(21)

No. 03-892
Title: Commissioner of Internal Revenue, Petitioner
v.
John W. Banks, II
Docketed: December 19, 2003
Lower Ct: United States Court of Appeals for the Sixth Circuit
Case Nos.: (01-2171, 01-2177)
Decision Date: September 30, 2003
Questions Presented

~~Date~~	~~~~~~~Proceedings and Orders~~~~~~~~~~~~~~~~~~~~~~
Dec 19 2003	Petition for a writ of certiorari filed. (Response due January 20, 2004)
Jan 14 2004	Waiver of right of respondent John W. Banks, II to respond filed.
Jan 21 2004	DISTRIBUTED for Conference of February 20, 2004.
Jan 30 2004	Response Requested . (Due February 27, 2004)
Feb 27 2004	Brief of respondent John W. Banks, II in opposition filed.
Mar 10 2004	DISTRIBUTED for Conference of March 26, 2004.
Mar 11 2004	Reply of petitioner Commissioner of Internal Revenue filed. (Distributed)
Mar 29 2004	Petition GRANTED. This case is consolidated with No. 03-907 CIR v. Banaitis and a total of one hour is allotted for oral argument.
May 6 2004	Extension of time within which to file the joint appendix and petitioner's brief on the merits to and including June 11, 2004. VIDED
Jun 11 2004	Brief amici curiae of Professor Gregg D. Polsky and Professor Brant J. Hellwig filed. VIDED.
Jun 11 2004	Joint appendix filed. VIDED.
Jun 11 2004	Brief of petitioner Commissioner of Internal Revenue filed. VIDED.
Jun 28 2004	Extension of time within which to file respondent's brief on the merits to and including August 18, 2004. VIDED
Aug 16 2004	Brief amicus curiae of Stephen B. Cohen filed. VIDED.
Aug 16 2004	Brief amici curiae of Kenneth Gideon, et al. filed. VIDED.
Aug 17 2004	Brief amici curiae of Mountain States Legal Foundation, et al. filed. VIDED.
Aug 17 2004	Brief amicus curiae of Oregon Trial Lawyers Association filed. VIDED.
Aug 18 2004	Brief of respondent John W. Banks, II filed.
Aug 18 2004	Brief amicus curiae of Taxpayers Against Fraud Education Fund filed. VIDED.
Aug 18 2004	Brief amicus curiae of Equal Employment Advisory Council filed. VIDED.
Aug 18 2004	Brief amici curiae of Lawyers' Cmmittee for Civil Rights Under Law, et al. filed. VIDED.
Aug 18 2004	Brief amicus curiae of Association of Trial Lawyers of America filed. VIDED.
Aug 18 2004	Brief amici curiae of National Employment Lawyers Association, et al. filed. (VIDED)
Aug 18 2004	Brief amicus curiae of Charles Davenport filed. VIDED.
Aug 18 2004	Motion to allow James R. Carty to argue pro hac vice filed by respondent.
Aug 27 2004	Motion for additional time to argue and for divided argument filed by respondents. (VIDED)
Sep 1 2004	SET FOR ARGUMENT Monday, November 1, 2004.
Sep 10 2004	Motion to allow David B. Salmons to argue pro hac vice filed by the Solicitor General.

	(VIDED)
Sep 15 2004	CIRCULATED.
Sep 21 2004	Record received from U.S.C.A. - 6th Circuit. (1 binder)
Sep 22 2004	Reply of petitioner Commissioner of Internal Revenue filed. VIDED. (Distributed)
Sep 24 2004	Record received from U.S. Tax Court. (1 folder, 1 box)
Sep 28 2004	Motion for additional time to argue by respondent The motion of respondents for divided argument is granted. The motion of respondents for additional time for oral argument is denied.
Sep 28 2004	Motion to allow David B. Salmons to argue pro hac vice GRANTED.
Sep 28 2004	Motion to allow James R. Carty to argue pro hac vice GRANTED.
Oct 22 2004	Supplemental brief of respondents John W. Banks, II and Sigitas Banaitis filed. VIDED. (Distributed) (TBP)
Oct 25 2004	Supplemental brief of petitioner Commissioner of Internal Revenue filed. VIDED. (Distributed)
Nov 1 2004	Argued. For petitioner: David B. Salmons, Assistant to the Solicitor General, Department of Justice, Washington, D.C. (pro hac vice.) For respondent Banaitis: Philip N. Jones, Portland, Ore. For respondent Banks: James R. Carty, Los Angeles, Calif. (pro hac vice.)

Supreme Court, U.S.
FILED

03 892 DEC 19 2003

OFFICE OF THE CLERK

No.

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN W. BANKS, II

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether, under Section 61(a) of the Internal Revenue Code, 26 U.S.C. 61(a), a taxpayer's gross income from the proceeds of litigation includes the portion of his damages recovery that is paid to his attorneys pursuant to a contingent fee agreement.

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In the Supreme Court of the United States

No.

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN W. BANKS, II

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the Commissioner of Internal Revenue, petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Sixth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-33a) is reported at 345 F.3d 373. The opinion of the Tax Court (App., *infra*, 34a-57a) is unofficially reported at 81 T.C.M. (CCH) 1219.

JURISDICTION

The judgment of the court of appeals was filed on September 30, 2003. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 61(a) of the Internal Revenue Code, 26 U.S.C. 61(a), provides as follows:

SECTION 61. GROSS INCOME DEFINED

(a) General Definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

STATEMENT

This case presents the question whether litigation proceeds paid as attorneys fees pursuant to a contingent fee agreement constitute income to the plaintiff for federal income tax purposes. That question has divided the circuits, and the decision of the Sixth Circuit in this case exacerbates that conflict on an issue of recurring importance.

1. Respondent worked as an educational consultant with the California Department of Education from 1972 until 1986, when his employment was terminated. In response to his termination, respondent filed a civil action against the state agency and various of its past and present employees in the United States District Court for the Eastern District of California. He claimed (i) that his termination violated state and federal prohibitions against employment discrimination (42 U.S.C. 1981, 1983; Cal. Gov't Code § 12965 (West Supp. 2003)); and (ii) that, in connection with his termination, the defendants committed the state-law torts of slander and intentional infliction of emotional distress. Respondent sought general damages, future medical and hospital expenses, punitive and exemplary damages, back pay and related employee benefits, an injunction and attorney's fees. Respondent's attorney agreed to represent him in that action for a contingent fee. App., *infra*, 2a.

On May 30, 1990, after trial had begun, respondent entered into an agreement with defendants that settled all of his claims for $464,000. Pursuant to the contingent fee agreement, respondent paid $150,000 of the settlement proceeds to his attorney. App., *infra*, 4a-5a.

Respondent did not include any part of the $464,000 settlement proceeds in his gross income on his 1990 federal income tax return. App., *infra*, 5a. On audit, the Commissioner determined that the entire amount of the settlement proceeds constituted "gross income" to respondent under Section 61(a) of the Internal Revenue Code, 26 U.S.C. 61(a). The Commissioner further determined (i) that the amount paid to his attorney pursuant to the contingency fee agreement was a deductible expense in earning that income but, (ii) since attorney's fee expenses fall within the category of "miscellaneous itemized deduction[s]," they are given no consideration in computing the alternative minimum tax (AMT) under 26 U.S.C. 56(b)(1)(A)(i). As a consequence of these determinations, a tax deficiency in the amount of $10,625 was issued for respondent's AMT liability. App., *infra*, 35a.[1]

2. Respondent sought review of the Commissioner's determinations in the Tax Court. The Tax Court agreed with the Commissioner that respondent was required to include the entire settlement proceeds in his gross income, including the portion paid to his attorneys as a contingent fee. The court therefore sustained the Commissioner's determination of respondent's AMT liability. App., *infra*, 49a-52a.

3. a. The court of appeals sustained the Tax Court's holding that the portion of the damages that respondent received and retained represented taxable income

[1] In addition, the Commissioner determined that the portion of the damages award that respondent received and retained was taxable income that is not exempt from tax as a recovery for a "personal injury" under Section 104 of the Code, 26 U.S.C. 104. The courts below upheld that determination. App., *infra*, 8a-17a; see *United States* v. *Burke*, 504 U.S. 229, 239-241 (1992). That determination is not at issue in this petition.

to him. App., *infra*, 8a-17a; see note 1, *supra*. The court of appeals, however, reversed the Tax Court's holding that respondent may not exclude from his gross income the portion of the settlement proceeds that were paid to his attorney under the contingent fee agreement. App., *infra*, 17a-25a.

The contingent fee agreement involved in this case was made under California law. In *Benci-Woodward* v. *Commissioner*, 219 F.3d 941, 943 (2000), cert. denied, 531 U.S. 1112 (2001), the Ninth Circuit held that, "[u]nder California law, an attorney lien does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients." The court therefore concluded that the portion of the damages paid to the attorneys under a contingent fee agreement in California was part of the gross income of the plaintiff. The Ninth Circuit reached a similar conclusion under Alaska law in *Coady* v. *Commissioner*, 213 F.3d 1187, 1190 (2000), cert. denied, 532 U.S. 972 (2001), where the court held that the entire award of damages obtained under a contingent fee agreement is included in the taxpayers' gross income because Alaska law "does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients."

In the present case, the Sixth Circuit noted that the Ninth Circuit had held in *Benci-Woodward* that "California's lien statute confers no ownership interest on attorneys" and that "[c]ontingent fee contracts do not operate to transfer a part of the cause of action to the attorney but only give him a lien upon his client's recovery." App., *infra*, 23a (quoting *Benci-Woodward*, 219 F.3d at 943 (internal quotation marks omitted)). The Sixth Circuit, however, disagreed with the conclu-

sion reached by the Ninth Circuit in *Benci-Woodward*. The court stated that it instead found "persuasive" the reasoning of the Fifth Circuit in *Srivastava* v. *Commissioner*, 220 F.3d 353 (5th Cir. 2000), and concluded that the answer to this question "does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state." App., *infra*, 23a-24a (quoting *Srivastava* v. *Commissioner*, 220 F.3d at 364). The Sixth Circuit panel stated in this case (App., *infra*, 24a):

> We likewise are not inclined to draw distinctions between contingency fees based on the attorney's lien law of the state in which the fee originated. Given the various distinctions among attorney's lien laws among the fifty states, such a "state-by-state" approach would not * * * provide sufficient notice to taxpayers as to our tax treatment of contingency-based attorneys fees paid from their respective jury awards.

The Sixth Circuit had previously held in *Estate of Clarks* v. *United States*, 202 F.3d 854 (2000), that the portion of a lawsuit recovery paid as contingent attorney's fees in Michigan should be excluded from the plaintiff's gross income. The Sixth Circuit panel stated in this case that (App., *infra*, 25a):

> The *Estate of Clarks* holding does not primarily rest on the rationale that separate state lien laws governing attorneys' rights determine the correct characterization of an attorney contingency fee. We therefore hold that *Estate of Clarks* is controlling in the present case, notwithstanding the difference in Michigan's and California's respective attorney's lien laws. In so holding, we will follow our precedent without protracted inquiries into "the intricacies of an attorney's bundle of rights." *Srivastava*, 220 F.3d at 364.

The court thus concluded that the $150,000 portion of respondent's recovery that was paid to his attorney as a contingent fee was not part of his gross income and therefore not subject to tax under the Internal Revenue Code. App., *infra*, 25a.

b. Judge Moore dissented on this issue. She stated that "California law, as explained by the California Supreme Court and the Ninth Circuit [in *Benci-Woodward*], clearly treats the attorney's contingency-fee contract as simply a security interest and not as an ownership interest." App., *infra*, 32a. She concluded that "the proceeds the taxpayer paid to his attorney as a contingency fee should be included in the taxpayer's income." *Ibid.*

REASONS FOR GRANTING THE PETITION

The decision of the court of appeals is in direct conflict with the decision of the Ninth Circuit in *Benci-Woodward* v. *Commissioner*, 219 F.3d 941 (2000), cert. denied, 531 U.S. 1112 (2001). In *Benci-Woodward*, the Ninth Circuit held that the portion of a damages award that was paid to the taxpayer's attorneys under a contingent fee agreement governed by the laws of California was to be included in the taxpayer's gross income. In the instant case, which also involved a contingent fee agreement executed in California, the Sixth Circuit majority held that the portion of respondent's settlement proceeds that was paid to his attorney was to be excluded from his gross income. The court concluded in this case that, regardless of any differences in state law concerning the rights of attorneys under contingent fee agreements, the portion of a damage award paid to the plaintiff's attorneys pursuant

to a contingent fee agreement is always to be excluded from the plaintiff's gross income. In so holding, the Sixth Circuit created a direct conflict not only with the Ninth Circuit's decision in *Benci-Woodward*, but also with the Fourth Circuit's decision in *Young* v. *Commissioner*, 240 F.3d 369 (2001), the Seventh Circuit's decision in *Kenseth* v. *Commissioner*, 259 F.3d 881 (2001), and the Tenth Circuit's decision in *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d 1312 (2001), cert. denied, 535 U.S. 1056 (2002). The broad rule of exclusion adopted by the court of appeals in this case also cannot be reconciled with the decisions in *Baylin* v. *United States*, 43 F.3d 1451 (Fed. Cir. 1995), *O'Brien* v. *Commissioner*, 319 F.2d 532 (3d Cir. 1963), aff'g 38 T.C. 707 (1962), cert. denied, 375 U.S. 931 (1963), and *Coady* v. *Commissioner*, 213 F.3d 1187 (9th Cir. 2000), cert. denied, 532 U.S. 972 (2001).

Contingent fee agreements are a standard feature in tort litigation and are common in other types of litigation as well. The issue presented in this case therefore recurs frequently and has substantial importance to the proper administration of the tax laws. This Court has stressed the importance of avoiding "inequalities in the administration of the revenue laws." *Commissioner* v. *Sunnen*, 333 U.S. 591, 599 (1948). Resolution by this Court of the widespread and irreconcilable conflict among the courts of appeal is needed to eliminate the disparate treatment of similarly situated taxpayers that now exists.

1. The decision of the Sixth Circuit in this case fails properly to apply elementary tax principles. It is a fundamental rule of taxation that income is to be taxed to the person who earns it, even when it is paid at that person's direction to someone else. *Lucas* v. *Earl*, 281 U.S. 111, 114-115 (1930). Respondent was the sole

plaintiff of the causes of action that were settled by him for $464,000. The settlement proceeds represent the value given in exchange for the dismissal of his claims. The entire amount of that value is income to respondent, subject to whatever deductions are allowed under the Code. *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d at 1313-1314; *Kenseth* v. *Commissioner*, 259 F.3d at 884-885; *Young* v. *Commissioner*, 240 F.3d at 378. While attorneys fees are ordinarily deductible in calculating taxable income, they are not deductible in calculating the alternative minimum tax, which applies in this case. 26 U.S.C. 56(b)(1)(A)(i); see *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d at 1313; *Benci-Woodward* v. *Commissioner*, 219 F.3d at 944.

The Sixth Circuit incorrectly held in this case that the portion of the damage recovery paid, at respondent's direction, to his attorney is *not* part of respondent's gross income. In reaching that conclusion, the court of appeals did not reject or attempt to refute the settled law in California that the attorney acquired only a lien, and not a proprietary interest, in respondent's cause of action under the contingent fee agreement. See *Benci-Woodward*, 219 F.3d at 943. The court instead stated that a contingent fee has the effect of "a partnership or joint venture" and, as a consequence, permits the income to be paid directly to the attorney from the proceeds of the litigation without ever coming into the possession of the client. App., *infra*, 24a.

The fact that a direct payment of the attorneys fees was made out of the proceeds of the litigation, however, does not support the exclusion from income established by the Sixth Circuit in this case. This Court has made clear that an "anticipatory assignment" of income—that directs that income to be received in the future is to be paid directly to the taxpayer's assignee—is inef-

fective to shift the incidence of the tax away from the party who assigned the right to receive the income. *Lucas* v. *Earl*, 281 U.S. at 114-115; *Helvering* v. *Horst*, 311 U.S. 112, 114 (1940). In several cases involving facts similar to this case, courts have applied this basic tax principle in concluding that the gross amount of a damages recovery is income to the plaintiff, subject to such deductions for attorneys fees as the Code allows. See *Kenseth* v. *Commissioner*, 259 F.3d at 884-885; *Young* v. *Commissioner*, 240 F.3d at 378; *Baylin* v. *United States*, 43 F.3d at 1451.

There is, moreover, nothing to support the suggestion of the court of appeals in this case that a contingent fee agreement operates "like a partnership or joint venture" and effects an assignment to the attorney of a portion of the proceeds of the cause of action. App., *infra*, 24a. Under California law, which applies to the fee agreement in this case, a contingent-fee contract does *not* effect an assignment of a portion of the cause of action. *Kenseth* v. *Commissioner*, 259 F.3d at 884. Instead, the contingent fee agreement constitutes a promise by respondent to pay his attorney a portion of the proceeds of the litigation as compensation for services rendered. *Ibid.* The relationship between respondent and his attorney was thus simply that of debtor and creditor. It is well settled that, when a debt owed by a taxpayer is satisfied by a direct payment from a third party to the taxpayer's creditor, the taxpayer receives "income" in the amount of the discharged debt. *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 729 (1929); see *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d at 1313-1314; *Baylin* v. *United States*, 43 F.3d at 1454.

Even if it were assumed, for purposes of argument, that respondent made an *actual* assignment to his

attorney of a portion of the proceeds of his cause of action, an assignment of a right to receive income, for services rendered, would not shift the incidence of tax away from respondent. The taxpayer cannot avoid tax on the income he has earned by the simple artifice of having it paid, for his benefit, to someone else. See, *e.g.*, *Helvering* v. *Horst*, 311 U.S. at 114; *Lucas* v. *Earl*, 281 U.S. at 114-115; *Kenseth* v. *Commissioner*, 259 F.3d at 884-885; *Young* v. *Commissioner*, 240 F.3d at 378; *Baylin* v. *United States*, 43 F.3d at 1451.[2]

2. a. In short, an exclusion from gross income for amounts paid from a damages recovery to satisfy a contingent attorneys fees obligation is not defensible on any ground. As Judge Posner explained in *Kenseth* v. *Commissioner*, 259 F.3d at 882:

> Taxable income is gross income minus allowable deductions. 26 U.S.C. § 63(a); *United States* v. *Whyte*, 699 F.2d 375, 378 (7th Cir. 1983). If a taxpayer obtains income of $100 at a cost in generating that income of $25, he has gross income of $100 and a deduction of $25, see § 162(a), yielding taxable income of $75; he does not have gross income of $75. If, therefore, for some reason the cost of generating the income is not deductible, he has taxable income

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[2] For example, if a professional athlete agreed to assign 10% of his compensation to his agent as a commission, and that commission was thereafter paid directly to the agent by the athlete's employer, the player obviously would not be allowed to exclude the amount of the commission from his gross income. Similarly, if an employer withholds a portion of an employee's wages and pays the withheld amount to the employee's former spouse in satisfaction of the employee's child-support obligation, the employee could not claim an exclusion for the portion of his wages that was paid directly to his former wife. These examples, however, are indistinguishable in character from respondent's claim in this case.

of $100. See § 62(a)(1) and, with specific reference to legal fees incurred for the production of income, *Alexander* v. *IRS*, 72 F.3d 938, 944-46 (1st Cir. 1995). That is Kenseth's situation under the alternative minimum tax.

He concedes as he must that had he paid the law firm on an hourly basis, the fee would have been an expense. It would have been a deduction from, not a reduction of, his gross income, as held in the *Alexander* case. We cannot see what difference it makes that the expense happened to be contingent rather than fixed.

While numerous courts have properly applied these basic tax principles in cases involving contingent fee recoveries, a few courts have incorrectly held that, if state law treats the contingent fee arrangement as effecting an "assignment" or transfer of a portion of the cause of action, that anticipatory assignment avoids the requirement that such income be recognized by the tort plaintiff upon the distribution of the recovery to his attorney. See *Srivastava* v. *Commissioner*, 220 F.3d 353 (5th Cir. 2000); *Davis* v. *Commissioner*, 210 F.3d 1346 (11th Cir. 2000); *Foster* v. *United States*, 249 F.3d 1275 (11th Cir. 2001); *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959). See also *Banaitis* v. *Commissioner*, 340 F.3d 1074 (9th Cir. 2003); *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2000). Judge Wisdom correctly pointed out in dissent in *Cotnam*, 263 F.2d at 126-127, that such decisions (as well as the decision in this case) cannot be reconciled with this Court's assignment-of-income decisions. Under the governing "principles set forth in *Helvering* v. *Horst*," the tort plaintiff must include the entire recovery in income when she (*ibid.*):

> controlled the disposition of the entire amount [of the claim] and diverted part of the payment from herself to the attorneys. By virtue of the assignment [the plaintiff] enjoyed the economic benefit of being able to fight her case through the courts and discharged her obligation to her attorneys (in itself equivalent to receipt of income, under *Old Colony Trust Co.* v. *Commissioner*, [279 U.S. 716 (1929)).]

b. The decision of the court of appeals in this case also directly conflicts with the decision of the Ninth Circuit in *Benci-Woodward* v. *Commissioner*, 219 F.3d at 943. In *Benci-Woodward*, the Ninth Circuit explained that a contingent fee agreement made under California law does not transfer to the attorney any proprietary interest in the client's cause of action; instead, it gives the attorney only a lien on the client's prospective recovery. The court reasoned that it therefore necessarily follows that the entire amount of the damages awarded to the taxpayer, including the portion that is paid directly to the taxpayer's attorneys under the contingent fee agreement, must be included in the taxpayer's gross income. *Ibid.*

In reaching the opposite conclusion in this case, the Sixth Circuit did not take issue with the Ninth Circuit's interpretation of California law. Instead, the Sixth Circuit held (i) that the state laws that determine the nature of contingent fee agreements are irrelevant and (ii) that attorney fees paid directly out of the proceeds of the plaintiff's cause of action should not, in any event, be regarded as income to the plaintiff. App., *infra*, 23a. In reaching that conclusion, the court made no effort to

reconcile its decision in this case with the Ninth Circuit's contrary holding in *Benci-Woodward*.[3]

c. The decision of the Sixth Circuit in this case also directly conflicts with the decisions of the Fourth and Seventh Circuits in *Young* v. *Commissioner*, *supra*, and *Kenseth* v. *Commissioner*, *supra*. In *Young*, the Fourth Circuit agreed with the Sixth Circuit that "whether amounts paid directly to attorneys under a contingent fee agreement should be included within the client's gross income should be resolved by proper application of federal income tax law, not the amount of control state law grants to an attorney over the client's cause of action." 240 F.3d at 378. Contrary to the decision of the Sixth Circuit in this case, however, the court in *Young* held that basic principles of federal tax law require the entire amount of a plaintiff's recovery —including the portion paid directly to the plaintiff's attorney under a contingent fee agreement—to be included in the plaintiff's gross income. The court held in *Young* that anticipatory assignment principles require this conclusion and explained that (*id.* at 377-378):

[3] The Sixth Circuit court suggested (App., *infra*, 23a) that its holding in this case is consistent with the decision of the Fifth Circuit in *Srivastava* v. *Commissioner*, 220 F.3d 353, 363-364 (2000). The *Srivastava* court indicated that, if it were writing on a clean slate, it would be inclined to hold that the entire amount of a damages award, including the portion paid to the plaintiff's attorney, is includible in the plaintiff's income. 220 F.3d at 363. That court held, however, that it was bound to follow the earlier decision of the Fifth Circuit in *Cotnam* v. *Commissioner*, *supra*, in which the court held, under Alabama law, that a contingent fee represents an assignment of a portion of the action and that fees paid out of the proceeds of the plaintiff's lawsuit were therefore excludable from her income. 263 F.2d at 125.

> If her attorneys charged an hourly rate, Mrs. Young would certainly have to include within her gross income any income used to pay her legal fees, whether the income came from the settlement proceeds or otherwise. We see no reason to allow her to escape taxation on a portion of the settlement proceeds simply because she arranged to compensate her attorneys directly from the proceeds through a contingent fee arrangement.

The Seventh Circuit in *Kenseth* reached the same conclusion as the Fourth Circuit in *Young*. The court noted in *Kenseth* that, under Wisconsin law (as under the California law applicable in this case), a contingent fee agreement does not give the attorney a proprietary interest in his client's cause of action. 259 F.3d at 883-884. The court explained that there was therefore no basis for excluding the portion of the recovery paid to the attorney under a contingent fee agreement from the income of the plaintiff (*id.* at 884):

> [I]f a contingent-fee lawyer expends effort on behalf of his client, who then terminates the contingent-fee contract, in effect confiscating the lawyer's work, the lawyer has a claim against the client; but he is no different in this respect from any other trade creditor stiffed by his debtor. In essence, Kenseth wants us to recharacterize this as a case in which he assigned 40 percent of his tort claim to the law firm. But he didn't. A contingent-fee contract is not an assignment, *Young* v. *Commissioner*, *supra*, 240 F.3d at 378; and in Wisconsin the lawyer is prohibited from acquiring ownership of his client's claim. So what Kenseth really is asking us to do is to assign a portion of *his income* to the law firm, but of course an assignment of income (as distinct from the

assignment of a contract or an asset that generates income) by a taxpayer is ineffective to shift his tax liability.

d. The decision of the Sixth Circuit in this case also cannot be reconciled with the decision of the Tenth Circuit in *Hukkanen-Campbell* v. *Commissioner*, *supra*. The Tenth Circuit held in *Hukkanen-Campbell* that the taxpayer could *not* exclude from her gross income the portion of her taxable recovery that was retained by her attorneys under a contingent fee agreement. The court agreed that the question of federal tax law addressed in these cases should not turn on the provisions of state law dealing with the rights of attorneys under contingent fee agreements. The court concluded, however, that federal tax principles require the tort plaintiff to recognize as income the portion of the recovery that she used to pay her attorneys fees (274 F. 3d at 1314):

> We agree with Petitioner that a universal standard independent of the "intricacies of any attorney's bundle of rights," or the unique provisions of a particular state's attorney lien statute is desirable. However, her proposed solution is inconsistent with the Tax Code. The correct approach is much more simple. Petitioner's judgment is a recovery of lost income; the attorney fees she paid represent expenses incurred in generating that income. Like any other taxpayer, Petitioner must report the entire amount as gross income, and, but for the AMT's provisions, she would be allowed to deduct her attorney fees as an expense. The Tax Code mandates this result irrespective of a particular state's attorney lien statute's provisions.

e. The decision in this case also conflicts with the appellate decisions that rejected an exclusion from gross income for contingent attorneys fees on the rationale that, under the state law that governed the fee agreement, no assignment of any portion of a cause of action had occurred. See *Baylin* v. *United States*, 43 F.3d 1451; *Coady* v. *Commissioner*, 213 F.3d 1187. The Sixth Circuit held in this case that the portion of a recovery paid as contingent attorneys fees is to be excluded from gross income in *every* case, regardless of how state law may vary in defining the rights of attorneys under such agreements. App., *infra*, 23a-24a.

3. The question addressed in these cases has substantial importance to the proper administration of the tax laws. Contingent fee agreements are a common feature in many types of litigation. The question presented in this case therefore recurs with significant frequency. Moreover, the extensive litigation over this issue has yielded a steady diet of conflicting decisions. Because of the widespread conflict in the decisions of the courts of appeals, taxpayers who are otherwise similarly situated have received disparate tax treatment based solely on the circuit in which they reside. Review by this Court of the decision below is warranted to eliminate this inconsistent treatment of taxpayers and to prevent "inequalities in the administration of the revenue laws." *Commissioner* v. *Sunnen*, 333 U.S. at 599.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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DECEMBER 2003

APPENDIX A

UNITED STATES COURT OF APPEALS
SIXTH CIRCUIT

Nos. 01-2171, 01-2177

JOHN W. BANKS, II, PETITIONER-APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT-APPELLEE

Decided and Filed: Sept. 30, 2003

OPINION

CLAY, Circuit Judge.

This is a consolidated appeal from a decision of the United States Tax Court. In Case Nos. 01-2171 and 01-2177, Petitioner John W. Banks, II appeals from the tax court's decision in favor of the Commissioner of Internal Revenue finding, *inter alia*, deficiencies in Petitioner's income tax due for the taxable year 1990 in the amount of $99,068.00. In an accompanying memorandum opinion, the tax court ruled, *inter alia*, that (1) Petitioner could not exclude from gross income money he received pursuant to an out-of-court settlement, including the portion thereof his attorney had received as a contingency fee; and (2) Petitioner was not entitled

to an income tax deduction in the taxable year 1990 for payments made to his former spouse as part of their divorce settlement. *See Banks* v. *Comm'r*, 81 T.C.M. (CCH) 1219, 2001 WL 196751, 2001 Tax Ct. Memo LEXIS 68 (Feb. 28, 2001). We **AFFIRM** in part and **REVERSE** in part the tax court's decision.

I. FACTUAL BACKGROUND

A. Petitioner's California Federal Court Lawsuit and Settlement

Petitioner worked as an educational consultant with the California Department of Education ("CDOE") from 1972 to 1986, when he was terminated. In response to his termination, Petitioner filed a civil action against the CDOE (and various past and present employees therein) in the federal district court for the Eastern District of California. Petitioner's second amended complaint alleged six counts. Counts 1, 2, and 3 alleged employment discrimination in violation of 42 U.S.C. §§ 1981 and 1983; Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. §§ 2000e to 2000e-17 (2000); and California Government Code § 12965, respectively. Counts 4, 5, and 6 asserted state law tort claims; specifically, Count 4 alleged intentional infliction of emotional distress, and Counts 5 and 6 alleged slander. Petitioner's lawsuit sought general damages, future medical and hospital expenses, punitive and exemplary damages, back pay and related employee benefits, various injunctions, and attorney's fees. In bringing the lawsuit Petitioner retained an attorney who agreed to represent Petitioner pursuant to a contingency fee agreement.

Settlement attempts failed, and Petitioner's case proceeded toward trial. The district court entered a

final pretrial conference order on September 22, 1989. Under the "Abandoned Issues" section, the pretrial order stated, "[Petitioner] has abandoned all claims for damages relative to state tort claims, including a claim for intentional and negligent imposition of emotional distress, tortious interference with business relations, and defamation." (J.A. at 148.) Thus, according to the pretrial order, Petitioner abandoned Counts 4, 5, and 6 of the second amended complaint, leaving the remaining claims (by process of elimination) as Counts 1, 2, and 3, *i.e.*, the violations of Title VII, 42 U.S.C. § 1981, and 42 U.S.C. § 1983. The fact that the §§ 1981 and 1983 claims were still being litigated was evidenced elsewhere in the order, both in the "Points of Law" section (where the district court directed the parties to brief "[t]he elements, standards and burdens of proof relative to" §§ 1981 and 1983 claims) (J.A. at 147-48), and in the "Disputed Factual Issues" section (which includes the issue of "[w]hether the defendants acted under color of state law to deprive [Petitioner] of his rights, privileges and immunities secured by the Constitution by engaging in discriminatory practices").[1] (J.A. at 141- 42.) Abandoning counts 4, 5, and 6, in itself, did not eliminate any of the forms of relief Petitioner originally had requested in his second amended complaint. However, the "Relief Sought" section of the pretrial order indi-

[1] The phrasing of this issue fairly represents the language of § 1983, which provides that "[e]very person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory or the District of Columbia, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for redress."

cated the following: "[Petitioner] seeks only reinstatement, back pay, and attorneys' fees." (J.A. at 147.) The limitation on relief sought was also confirmed in the part of the pretrial order calling for a non-jury trial: "Although plaintiff had heretofore demanded a jury trial, he concedes that *since he now seeks only back pay and equitable relief,* a jury trial is not appropriate." (J.A. at 132) (emphasis added).

Petitioner's trial commenced, and nine days into the trial, at the court's urging, the parties held a settlement conference. Testimony at the tax court trial from Petitioner's attorney in the California federal court action, as well as a letter from Petitioner to an Internal Revenue Service ("IRS") agent, indicated that Petitioner had initially requested $850,000 during settlement discussions, and that he and his attorney had arrived at that proposed settlement figure based on Petitioner's salary. The defendants countered with an offer of $464,000, apparently arguing that Petitioner should take less money because he could designate the amount as personal injury damages and render it nontaxable. Petitioner and his attorney agreed to the $464,000 settlement amount, so long as it could be characterized in the settlement agreement as compensation for personal injury damages. However, Petitioner's attorney testified at the tax court trial that he warned Petitioner that although the settlement agreement could characterize the $464,000 proceeds as personal injury damages, there was no guarantee that the IRS would subsequently agree to this characterization.

On May 30, 1990, Petitioner and the CDOE entered into an agreement that settled all of Petitioner's

outstanding claims for $464,000. The agreement provided, in part, as follows:

> 1. The [CDOE] agrees object [sic] to pay to [Petitioner] of the sum of $464,000.00 in full and complete satisfaction of his claims. [Petitioner] characterizes this payment of $464,000.00 as payment for personal injury damages suffered after [Petitioner's] discharge on July 14, 1986.

(J.A. at 159.) Of this $464,000, Petitioner paid $150,000 to his attorney in fees, pursuant to the contingency fee arrangement between them. Petitioner did not include any of the $464,000 settlement proceeds as gross income on his 1990 federal income tax return.

B. Petitioner's Alimony Payment to His Former Spouse and Deduction

On November 1, 1984, the marriage of Petitioner and his first wife, Verna Banks, was dissolved. In adjudicating the impending dissolution, the California Superior Court issued an order, dated January 2, 1984, declaring that Verna Banks was entitled to 43.95% of Petitioner's gross monthly military retirement payments. Pursuant to this order, Petitioner began making payments to Verna Banks, but the payments did not start until 1987 and only constituted 43.95% of Petitioner's net, rather than gross, retirement payments. Consequently, arrears immediately began to accrue to Verna Banks. On April 6, 1988 and December 4, 1989, Verna Banks obtained orders for the arrearage, plus attorney's fees, and she later returned to court to enforce the orders in 1990. On October 30, 1990, the California Superior Court, taking note of Petitioner's recent out-of-court settlement with the CDOE, ordered Petitioner to pay Verna Banks $12,156.81 out of the

$464,000 settlement proceeds from the civil lawsuit Petitioner had filed in federal district court in California. The court further ordered Petitioner to place an additional $20,000, plus $3,850 in attorney's fees, in an interest-bearing account until Petitioner began to make timely payments to Verna. The amounts the court ordered Petitioner to pay totaled $36,006.81.

In 1990, Petitioner paid $72,013.62 (double the $36,006.81 of the court's order in lieu of posting an appellate bond) into California Superior Court and filed several appeals, all of which ultimately proved unsuccessful. Eventually, Verna Banks agreed to receive Petitioner's $72,013 deposit in satisfaction of all arrears (except for $45,987 in arrears Petitioner owed Verna from 1979 to 1986). The court transferred the $72,013.62 to Verna in 1993, and Petitioner deducted the $72,013.62 in the 1993 tax year as an alimony payment deduction. However, at the tax court trial Petitioner argued that he was entitled to claim that deduction for the 1990 tax year.

C. The Commissioner's Notices of Deficiency and the Tax Court's Decision

On May 30, 1997, the Commissioner issued a Notice of Deficiency to Petitioner for the tax year ending December 31, 1990,[2] in the amount of $101,168.00. Petitioner filed a petition in the tax court, requesting a redetermination of the deficiencies. The cases were consolidated, and the matter proceeded to trial.

[2] The Notice actually determined deficiencies for three tax years: 1988, 1990, and 1991. However, only tax year 1990 is at issue in this appeal.

February 28, 2001, the tax court filed a Memorandum Findings of Fact and Opinion ("tax court opinion" or "opinion"). For purposes of this appeal, the tax court opinion made three relevant rulings. First, it determined that the entire $464,000 amount Petitioner received in settlement of his California federal court lawsuit constituted taxable income because, contrary to Petitioner's arguments, none of the settlement amount was attributable to a claim of personal injury. Second, the tax court determined that the $150,000 Petitioner had paid out of the $464,000 settlement amount to his lawyer as an attorney contingency fee was not excludable from income. Third, the tax court agreed with Petitioner that an alimony payment to Verna Banks could have been deducted from his gross income for the 1990 tax year, but it further held that Petitioner was now precluded by the "duty of consistency" doctrine from taking the deduction.

Consequently, the tax court held Petitioner liable for taxes on the full $464,000 settlement amount, and it disallowed any relevant deductions therefrom. A decision embodying these three rulings was entered on May 21, 2001.[3] Petitioner's timely appeal followed.

II. STANDARD OF REVIEW

We review the tax court's legal conclusions de novo and its factual findings for clear error. *Zack* v. *Comm'r*, 291 F.3d 407, 412 (6th Cir. 2002) (citing *MTS Int'l, Inc.* v. *Comm'r*, 169 F.3d 1018, 1021 (6th Cir. 1999)). We will conclude that a factual finding is clearly erroneous only if, upon our review of the entire record,

[3] Pursuant to these rulings (and other rulings which neither side appealed), the tax court ruled that there existed a deficiency for Petitioner's 1990 tax year in the amount of $99,068.000.

we are "left with the definite and firm conviction that a mistake has been committed." *Id.* (quoting *Sanford* v. *Harvard Indus., Inc.*, 262 F.3d 590, 595 (6th Cir. 2001)) (internal quotation marks omitted).

III. ANALYSIS

A. Whether the Amount Paid in Settlement of Petitioner's Lawsuit was Attributable to a Claim of Personal Injury.

Petitioner challenges on appeal the tax court's ruling that the $464,000 he received in settling his California federal civil action was not excludable from income under Internal Revenue Code § 104(a), 26 U.S.C. § 104(a). Specifically, Petitioner argues that the tax court erred in determining that no portion of the $464,000 settlement amount was attributable to personal injuries he alleged in that lawsuit. We are not persuaded by Petitioner's arguments and therefore affirm the tax court as to this issue.

Section 61 of the Internal Revenue Code states that "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived." 26 U.S.C. § 61(a). In determining what constitutes gross income, we construe § 61 "liberally 'in recognition of the intention of Congress to tax all gains except those specifically exempted.'" *Greer* v. *United States*, 207 F.3d 322, 326 (6th Cir. 2000) (quoting *Comm'r* v. *Glenshaw Glass Co.*, 348 U.S. 426, 430, 75 S. Ct. 473, 99 L.Ed. 483 (1955)).

Nevertheless, the Internal Revenue Code provides for a number of exclusions from income. One of these exclusions is found in § 104(a)(2), which permitted a taxpayer to exclude from income "the amount of any

damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness." 26 U.S.C. § 104(a)(2).[4] Damages received "on account of personal injuries" are to be distinguished from those received on account of back pay damages, for which no exclusion from income exists. *Comm'r* v. *Schleier*, 515 U.S. 323, 329-30, 115 S. Ct. 2159, 132 L.Ed.2d 294 (1995).

The Supreme Court has held that a § 104(a) exclusion is warranted only where a two-prong test has been satisfied. First, the taxpayer must have received the damages amount through the litigation of an action (or a settlement thereof) based on tort or tort-type rights. Second, the amount must be paid on account of personal injuries or sickness. *Schleier*, 515 U.S. at 337, 115 S. Ct. 2159. Moreover, regarding the second prong, a taxpayer must present "concrete evidence demonstrating the precise causal connection between" the taxpayer's asserted personal injuries and the settlement payment he or she received. *Greer*, 207 F.3d at 334. More recently, we "disaggregate [d]" the *Schleier* two-prong test into "its disparate elements," as follows:

> To satisfy *Schleier*, the taxpayer must show that
>
> (1) there was an underlying claim sounding in tort;
>
> (2) the claim existed at the time of the settlement;
>
> (3) the claim encompassed personal injuries; and

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[4] Section 104(a)(2) was amended in 1996 to limit exclusions from income for personal injuries or sickness to physical injuries or sickness. *See* Small Business Job Protection Act of 1996, Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838. However, because Petitioner's lawsuit settlement occurred prior to the passage of this amendment, this new limitation on § 104(a)(2) does not apply here. *See Greer*, 207 F.3d at 328.

(4) the agreement was executed "in lieu" of the prosecution of the tort claim and "on account of" the personal injury.

Id. at 327, 115 S. Ct. 2159.

Turning our attention to the first prong of the *Schleier* test, we observe that the proper inquiry "focus[es] on the origin and characteristics of the claims settled in determining whether such damages are excludible under § 104(a)(2)." *Id.* (quoting *Pipitone* v. *United States*, 180 F.3d 859, 862 (7th Cir. 1999)). A relevant aspect of this inquiry requires us to consider whether the claim at issue provides for remedies that "recompense [a plaintiff] for any of the . . . traditional harms associated with personal injury, such as pain and suffering, emotional distress, harm to reputation, or other consequential damages," *i.e.*, remedies other than economic damages. *See United States* v. *Burke*, 504 U.S. 229, 239, 112 S. Ct. 1867, 119 L.Ed.2d 34 (1992). Because Petitioner abandoned the state tort claims prior to trial, the relevant claims to examine in this case are Counts 1 through 3 of Petitioner's second amended complaint, which represent Petitioner's claims brought under Title VII, 42 U.S.C. § 1981, and 42 U.S.C. § 1983.

Applying this analysis, we agree with the Commissioner and the tax court that Petitioner's Title VII claim does not constitute "an underlying claim sounding in tort" for purposes of § 104(a)(2). Greer, 207 F.3d at 327. The Supreme Court has held that Title VII, at the time of Petitioner's civil lawsuit, "focuse[d] on legal injuries of an economic character," given that its "sole remedial focus [wa]s the award of back wages," and therefore did not "redress[ ] a tort-like personal injury within the meaning of § 104(a)(2) and the applicable regulations." *Burke*, 504 U.S. at 239, 241, 112 S. Ct.

1867. It is true that Congress amended Title VII in 1991 to provide Title VII plaintiffs with additional monetary relief beyond back pay. *See* Civil Rights Act of 1991, Pub. L. No. 102-166, § 102, 105 Stat. 1071, 1072-74 (1991) (codified at 42 U.S.C. § 1981a). However, Petitioner had sued the CDOE under the old version of Title VII ("pre-1991 Title VII"), and *Burke* directly controls the applicability of § 104(a)(2) to pre-Title VII damages. *Id.*[5]

Petitioner alternatively argues that his §§ 1981 and 1983 claims provide the requisite tort or tort-like claims on which to base his § 104(a)(2) exclusion. We agree with Petitioner. The Supreme Court has indicated (albeit in the statute of limitations, not the § 104(a)(2), context) that § 1983 claims constitute tort or tort-like actions. *See Wilson* v. *Garcia*, 471 U.S. 261, 280, 105 S. Ct. 1938, 85 L.Ed.2d 254 (1985) (holding that § 1983 claims "are best characterized as personal injury actions"); *see also City of Monterey* v. *Del Monte Dunes at Monterey, Ltd.*, 526 U.S. 687, 724-25, 119 S. Ct. 1624, 143 L.Ed.2d 882 (1999) (Scalia, J., concurring in part and concurring in the judgment) (applying Wilson's rule to a Seventh Amendment inquiry).[6] Furthermore,

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[5] Although Burke's authority has been questioned since the amendments to Title VII, its authority as to pre-1991 Title VII claims seems to be intact. *See, e.g., Abrams* v. *Lightolier Inc.*, 50 F.3d 1204, 1220 (3d Cir. 1995) ("We note that amendments to Title VII made by the Civil Rights Act of 1991 allow a plaintiff to recover compensatory and punitive damages and thus throw doubt on the continued validity of the Burke holding.") (emphasis added).

[6] Several other circuits have held that § 1983 actions are tort actions within the meaning of § 104(a)(2). *See Wulf* v. *City of Wichita*, 883 F.2d 842, 872-73 (10th Cir. 1989) (holding that the settlement proceeds of the taxpayer's § 1983 civil action compensated him for personal injuries and was excludable under

although the Supreme Court has not expressly designated § 1981 as constituting a tort or tort-like action, the Court strongly hinted in its Burke decision that it deemed § 1981 to fit into this category. *See Burke*, 504 U.S. at 240, 112 S. Ct. 1867 (observing that the remedies available under pre-1991 Title VII "st[ood] in marked contrast not only to those available under traditional tort law, but under other federal antidiscrimination statutes," for instance § 1981, which offered as potential remedies "both equitable and legal relief, including compensatory and, under certain circumstances, punitive damages").

The tax court had rejected Petitioner's alternative argument. Although the court conceded that § 1981 and 1983 claims constitute tort or tort- like actions, it found that, based on the district court's pretrial order entered in connection with his lawsuit against the CDOE, Petitioner had abandoned all of his tort claims, including the §§ 1981 and 1983 claims. The tax court therefore concluded that Petitioner's §§ 1981 and 1983 claims could not provide a basis for a § 104 exclusion because such claims did not exist at the time of settlement, as required by prong two of the § 104 analysis. Petitioner points to several places in the pretrial order as proof that, contrary to any ambiguous abandonment language in the pretrial order, his §§ 1981

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§ 104(a)(2)); *Metzger* v. *Comm'r*, 88 T.C. 834, 1987 WL 49302 (1987), aff'd, 845 F.2d 1013 (3d Cir. 1988) (holding that claims under 42 U.S.C. §§ 1981 and 1983, among others, constituted "personal injury" claims within the meaning of § 104(a)(2)); *Bent* v. *Comm'r*, 835 F.2d 67, 70 (3d Cir. 1987) (holding that the portion of the taxpayer's damages award pertaining to his § 1983 claim compensated him for his personal injuries and could properly be excluded under § 104(a)(2)).

and 1983 claims were pursued at trial and were in existence at the time of the parties' settlement in 1990.

We agree with Petitioner that the tax court erred in determining that Petitioner had abandoned his 42 U.S.C. §§ 1981 and 1983 actions. Both the "Points of Law" and the "Disputed Factual Issues" sections of the pretrial order indicated that issues related to §§ 1981 and 1983 causes of action were still being litigated. Therefore, Petitioner satisfied his burden regarding prong one, because he had litigated a claim sounding in tort, to wit, the §§ 1981 and 1983 claims. Similarly, Petitioner also satisfied prong number two because his §§ 1981 and 1983 claims existed at the time he settled his case with the CDOE, and the $464,000 amount he received was in settlement of those claims.

As to the third prong, we find that Petitioner's §§ 1981 and 1983 claims "potentially involved injuries that were personal." *Greer*, 207 F.3d at 328. As we have previously observed, §§ 1981 and 1983 claims can encompass such personal injuries as mental anguish, damage to character, or damage to a personal or professional reputation, *id.* (collecting cases), and these types of tangible and intangible harms were contemplated by § 104(a)(2) at the time that Petitioner's settlement agreement was executed. Petitioner specifically requested in his second amended complaint, among other forms of relief, general damages (for harassment, humiliation, and embarrassment suffered by Plaintiff), and future medical and hospital expenses. Any relief granted for these harms Plaintiff suffered could fairly be construed as compensating personal injuries within the meaning of § 104(a)(2). *See id.*

However, we find that Petitioner failed to meet his burden to show that the settlement agreement was

executed "on account of personal injuries or sickness." *Greer*, 207 F.3d at 334 (quoting *Schleier*, 515 U.S. at 330, 115 S. Ct. 2159) (internal quotation marks omitted). Our inquiry in this regard requires us to examine the settlement agreement's purpose and, absent a clear purpose, the payor's intent in settling the claims. *Greer*, 207 F.3d at 329 (citations omitted). A determination regarding a payor's intent requires us to "consider[ ] the amount paid, compar[e] the circumstances and amount paid to other agreements the company has entered into, consider[ ] the factual circumstances that led to the agreement, and weigh[ ] other facts that may reveal the employer's intent." *Greer*, 207 F.3d at 329 (citing *Pipitone*, 180 F.3d at 864-65).

In support of his contention that he satisfied the burdens set forth under the third and fourth prongs, Petitioner points to language in the settlement agreement, to wit, "[Petitioner] characterizes this payment of $464,000.00 as payment for personal injury damages suffered after [Petitioner's] discharge on July 14, 1986." (J.A. at 159.) The tax court rejected this language as self-serving and contradicted by other evidence in the record. Petitioner argues that the tax court clearly erred in failing to give appropriate weight to the characterization in the settlement agreement.

We agree with Petitioner that language in a settlement agreement can offer some probative evidence of how a settlement payment should properly be characterized for purposes of § 104(a)(2). *See, e.g., Bent* v. *Comm'r*, 87 T.C. 236, 246, 1986 WL 22165 (1986), *aff'd*, 835 F.2d 67, 70 (3d Cir. 1987). However, in this case the settlement agreement did not attempt to assess the damages of the lawsuit and allocate

Petitioner's recovery accordingly. *See Robinson* v. *Comm'r*, 102 T.C. 116, 128-29, 1994 WL 26303 (1994) (rejecting a settlement agreement's characterization of the settlement amount, which allocated 95% to mental anguish and 5% to lost profits, as "uncontested, non-adversarial, and entirely tax-motivated" and not accurately "reflect[ing] the realities of . . . [the parties'] settlement"). In the present case, Petitioner can point to no other evidence in the record that supports his characterization of the settlement payment. For instance, his second amended complaint sought general damages for future (presumably, anticipated) medical and hospital expenses, but at the time of settlement he offered no receipts or other information indicating that he had suffered medical expenses or intended to do so in the near future. Similarly, there is nothing in the record to reflect a numerical value Petitioner placed on his mental anguish. Indeed, the settlement agreement does not even indicate the CDOE's intent in paying the settlement amount; the agreement merely indicates that Petitioner characterizes the $464,000 payment as compensating him for personal injuries. The only intent on CDOE's part reflected in the record is its intent to dispose of the case in an expeditious manner and a willingness to acquiesce in Petitioner's tax-favorable characterization of the settlement proceeds. Petitioner's characterization of his own settlement payment, with no further support in the settlement agreement or elsewhere record, cannot control the issue.

Not only does Petitioner fail to point to any evidence in the record to support his characterization of the $464,000 settlement payment, the record contains several indicia tending to contradict Petitioner's

characterization. In particular, the pretrial order pertaining to Petitioner's California federal court lawsuit stated that the only "[r]elief [s]ought" at trial was "reinstatement, back pay, and attorneys' fees." (J.A. at 147.) This would suggest that the claim, at least at the time of settlement, no longer encompassed personal injuries, and that the settlement agreement was executed on account of non-personal injuries, to wit, economic injuries. Moreover, testimony from Petitioner's lawyer, as well as a letter from Petitioner to an IRS agent, indicated that Petitioner offered to settle for $850,000, a figure he computed based on salary, which represents economic damages as opposed to personal injuries. Petitioner nevertheless agreed to the defendants' counteroffer of $464,000, so long as he could characterize the payment amount in the settlement agreement as covering personal injuries. Based on the evidence favoring the Commissioner, the tax court's finding on this point was not clearly erroneous, and we decline to overturn it.

We agree with the Commissioner that the 1990 settlement of Petitioner's California federal court action against the CDOE and other defendants for $464,000 does not fall under the § 104(a)(2) exclusion from income. Although some of Petitioner's claims, at the time of the settlement, were "based upon tort or tort type rights," *Schleier*, 515 U.S. at 337, 115 S. Ct. 2159, Petitioner failed to meet his burden of showing that his §§ 1981 and 1983 claims were settled on account of his personal injuries. Specifically, Petitioner has not met his burden of establishing a causal connection between his $464,000 settlement payment and any personal injuries he may have suffered. Because the settlement amount could not be excluded under § 104(a)(2), it was

properly included as income under 26 U.S.C. § 61(a). We therefore affirm the tax court's determination on this issue.

B. Whether the Portion of Petitioner's Lawsuit Settlement Paid to His Attorney Under a Contingency Fee Arrangement was Excludable from Income.

Next, Petitioner argues that the tax court erred in holding that the $150,000 in contingency fees he paid to his attorney as part of the California federal court settlement was not excludable from his gross income. Petitioner specifically contends that the tax court's ruling in this regard contravened our precedent. The Commissioner argues that the tax court acknowledged our precedent but properly distinguished it based on differing facts. We agree with Petitioner and reverse the tax court's determination as to this issue.

There is a circuit split on the issue of whether contingency fees must be included in gross income.[7] The Commissioner has always taken the position that contingency fees must be included, based on the anticipatory assignment of income doctrine. This theory is most typically exemplified in two Supreme

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[7] The Fifth, Sixth, and Eleventh Circuits have held that contingency fees are excludable. *See Foster* v. *United States*, 249 F.3d 1275 (11th Cir. 2001); *Srivastava* v. *Comm'r*, 220 F.3d 353 (5th Cir. 2000); *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2000). The Third, Fourth, Seventh, Ninth, Tenth, and Federal Circuits have taken the opposite view. *See Campbell* v. *Comm'r*, 274 F.3d 1312 (10th Cir. 2001); *Kenseth* v. *Comm'r*, 259 F.3d 881 (7th Cir. 2001); *Young* v. *Comm'r*, 240 F.3d 369 (4th Cir. 2001); *Benci-Woodward* v. *Comm'r*, 219 F.3d 941 (9th Cir. 2000); *Coady* v. *Comm'r*, 213 F.3d 1187 (9th Cir. 2000); *Baylin* v. *United States*, 43 F.3d 1451 (Fed. Cir. 1995); *O'Brien* v. *Comm'r*, 38 T.C. 707, 1962 WL 1147 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963) (per curiam).

Court cases: *Lucas* v. *Earl*, 281 U.S. 111, 50 S. Ct. 241, 74 L.Ed. 731 (1930), and *Helvering* v. *Horst*, 311 U.S. 112, 61 S. Ct. 144, 85 L.Ed. 75 (1940). In Lucas, the taxpayer assigned one-half of his future salary to his wife to avoid paying taxes on the entire salary, and argued in litigation that because he had never actually received the income before distributing it to his wife, it was not income to him. The Supreme Court disagreed, reasoning that because the taxpayer had earned and created the right to receive and enjoy the benefit of the income before assigning it, he was subject to taxation on the entire salary. 281 U.S. at 114-15, 50 S. Ct. 241. The Court further emphasized that the fundamental purpose of the tax code—to tax income to those who create, earn and enjoy it—"could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." *Id.* at 115, 50 S. Ct. 241. Thus, the Court declined to honor attempts to attribute fruits "to a different tree from that on which they grew" and held the entire salary, not just half, constituted taxable income to the taxpayer. *Id.*

Similarly, in *Horst*, the taxpayer owned negotiable bonds. Shortly before their maturity date, he removed the interest coupons from the bonds and gave them to his son, who subsequently collected interest on them. 311 U.S. at 114, 61 S. Ct. 144. During litigation, the taxpayer argued that the interest payments were not taxable to him because he never received the interest payments. Again, the Supreme Court disagreed. Observing that "[t]he dominant purpose of the revenue laws is the taxation of income to those who earn or otherwise create the right to receive it and enjoy the

benefit of it when paid," it concluded that the tax established by the 1934 Revenue Act could not "fairly be interpreted as not applying to income derived from interest or compensation when he who is entitled to receive it makes use of his power to dispose of it in procuring satisfactions which he would otherwise procure only by the use of the money when received." *Id.* at 119, 61 S. Ct. 144 (alterations in original). Therefore, the Court reasoned, because the taxpayer had earned and created the right to receive and enjoy the benefit of the income by virtue of the fact that he owned the bonds and the interest generated therefrom was guaranteed to him when he transferred the coupons, the income could fairly be attributed to him for taxation purposes. *Id.* at 117-20, 61 S. Ct. 144. Again reasoning that "the fruit is not to be attributed to a different tree from that on which it grew," *id.* at 120, 61 S. Ct. 144 (citing *Lucas*, 281 U.S. 115, 50 S. Ct. 273, 74 L.Ed. 733), the Court held that the transferred coupons constituted taxable income to the taxpayer. *Id.*

Nevertheless, the first case to address the tax treatment of contingency fee arrangements declined to apply the assignment of income doctrine to contingency fee payments. In *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959), following a successful Alabama court lawsuit to enforce a contract, the taxpayer paid her legal counsel a portion of the judgment award, pursuant to a contingency fee arrangement between them. The Commissioner subsequently treated the taxpayer's entire judgment award, including the contingency fee portion, as taxable income and assessed tax deficiencies accordingly. The court held that the contingency fee portion of the judgment award was

not income to the taxpayer. In concluding that the anticipatory assignment of income doctrine did not apply to the contingency fee the taxpayer paid to her legal counsel, the *Cotnam* court looked to Alabama's attorney's lien statute, which at the time provided that

> [u]pon suits, judgments, and decrees for money, [attorneys] shall have a lien superior to all liens but tax liens, and no person shall be at liberty to satisfy said suit, judgment or decree, until the lien or claim of the attorney for his fees is fully satisfied; and attorneys at law shall have the same right and power over said suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them.

Id. at 125 n. 5 (citing Ala. Code § 64 (1940)). In other words, the *Cotnam* court reasoned, the statute provided an attorney with an equitable lien that effectively transferred part of the taxpayer's claim to the attorney. The practical consequence of Alabama's attorney's lien law was that an attorney in Alabama held an equity interest in both the cause of action and the judgment, and the taxpayer, as the client, was precluded from ever realizing income on that percentage of the judgment representing the contingency fee.

The *Cotnam* court declined to apply the anticipatory assignment of income doctrine, noting that, unlike the circumstances in *Lucas* and *Horst*, the attorneys' claim to payment lacked fair market value and that it was uncertain as to when or whether the attorneys' claim would attain value (given that contingency fees are only paid in the event of a successful outcome of the taxpayer's lawsuit). Indeed, the court noted, the claim was "worthless without the aid of skillful attorneys." *Id.* at

125. Therefore, the *Cotnam* court concluded, because (1) the contingency fee never passed through the taxpayer's hands or was controlled by the taxpayer, and (2) only the attorney's services resulted in converting the uncertain claim into an item of value, the taxpayer properly excluded the contingency fee portion of his judgment from his income. *Id.* at 127.

We adopted the *Cotnam* doctrine in *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2000). In that case, the taxpayer received a jury award in a Michigan state court personal injury suit, and the attorney received one-third of the judgment award and interest as a contingency fee. The taxpayer soon thereafter died, and the estate, when filing the taxpayer's income tax return, properly included in gross income the interest portion of the judgment, but excluded the portion of the amount contingency fee attributable to interest. *Id.* at 855. In holding that the exclusion was proper, we rejected the Commissioner's position for reasons similar to those articulated in *Cotnam*. First, we pointed out that Michigan's attorney lien law operates in essentially the same way as the Alabama statutory lien examined in *Cotnam*, and essentially amounted to an assignment of a portion of the potential judgment. The record had indicated that the client originally owned the underlying claim but then relinquished his right to receive payment for the lawyer's contingency fee portion of any judgment upon signing the contingency fee contract.

Like the *Cotnam* court, we then proceeded to reject the anticipatory assignment of income doctrine as applied to contingency fees. In distinguishing the *Earl* and *Horst* decisions, we reasoned that a contingency fee, as part of a litigation claim, was not already earned,

vested, or even relatively certain to be paid to the assignor, but instead was merely "an intangible, contingent expectancy," dependent upon the attorney's skills to realize any value from it. *Id.* at 857. We then compared the contingency fee arrangement to a division of property:

> Here the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract. Here the lawyer's income is the result of his own personal skill and judgment, not the skill or largess of a family member who wants to split his income to avoid taxation. The income should be charged to the one who earned it and received it, not . . . to one who neither received it nor earned it.

Id. at 858.

We then distinguished *Earl* and *Horst* on three additional grounds. First, unlike the true income assignments in *Earl* and *Horst*, no tax avoidance purpose motivated the contingency fee arrangement; rather a business purpose motivated it. *Id.* at 858, 202 F.3d 854. Second, unlike the *Earl* and *Horst* assignees who performed no services to earn their income, the attorney earned his income because the income resulted from his own skill and judgment. We also were motivated by the fact that applying the assignment of income doctrine to contingency fees would result in double taxation, whereas in *Earl* and *Horst*, the assignees could exclude what they received as gifts. *Id.* at 857, 858.

In the instant case, the tax court acknowledged the *Estate of Clarks* decision but distinguished it on the grounds that Petitioner's underlying lawsuit, from which his attorney's contingency fee was generated, took place in California. California's law on attorneys' contingency fees, unlike Alabama's law, does not operate under a lien theory. Rather, California's lien statute confers no ownership interest on attorneys, and "[c]ontingent fee contracts 'do not operate to transfer a part of the cause of action to the attorney but only give him a lien upon his client's recovery.'" *Benci-Woodward*, 219 F.3d at 943 (citations omitted). Thus, in California an attorney who is entitled to a contingency fee "acquires no more than a professional interest," *id.*, and is no different from an ordinary creditor who, if "stiffed" on his payment, would have to enforce the contract judicially. On appeal, Petitioner urges this Court not to draw distinctions based on the lien theory of the particular state in which an action arises. We agree with Petitioner.

We find persuasive the reasoning of the Fifth Circuit, which recently faced similar factual circumstances. In *Srivastava* v. *Comm'r*, 220 F.3d 353, 363-64 (5th Cir. 2000), the Commissioner argued that *Cotnam* was not controlling because the taxpayer's contingency fee agreement was controlled by Texas law, and Texas' attorney's lien statute did not provide attorneys with a superior claim lien against their clients' judgments or any ownership interests. The *Srivastava* court declined to distinguish *Cotnam* based on the differing state attorney's lien laws, instead determining that "the answer [as to whether to apply *Cotnam*] does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the

governing state." *Id.* at 364. We likewise are not inclined to draw distinctions between contingency fees based on the attorney's lien law of the state in which the fee originated. Given the various distinctions among attorney's lien laws among the fifty states, such a "state-by-state" approach would not provide reliable precedent regarding our adherence to the *Cotnam* doctrine or provide sufficient notice to taxpayers as to our tax treatment of contingency-based attorneys fees paid from their respective jury awards. *Cf. O'Brien* v. *Comm'r*, 38 T.C. 707, 712, 1962 WL 1147 (1962), *aff'd*, 319 F.2d 532 (3d Cir. 1963) (*per curiam*) (rejecting distinctions in applying the *Cotnam* doctrine, based upon differing state attorney's lien laws because it doubted "that the Internal Revenue Code was intended to turn upon such refinements").

More importantly, the reasoning in *Estate of Clarks* case seems to have been based on more than the nature of Michigan's lien law. To be sure, the similarity between Michigan's attorney's lien statute in *Estate of Clarks* and Alabama's attorney's lien statute in *Cotnam* played a role in the outcome. *Estate of Clarks*, 202 F.3d at 856. However, we found other factors persuasive in distinguishing contingency fees from *Lucas* and *Horst*, including the following: (1) the fact that the claim, at the time the contingency fee agreement was signed, was "an intangible, contingent expectancy," (2) taxpayer's claim was like a partnership or joint venture in which the taxpayer assigned away one-third in hope of recovering two-thirds; (3) no tax-avoidance purpose was at work with the contingency fee arrangement, as there ostensibly was in *Lucas* and *Horst*; and (4) double taxation would otherwise result by including the contingency fee in taxpayer's income. *Id.* at 857-58.

The *Estate of Clarks* holding does not primarily rest on the rationale that separate state lien laws governing attorneys' rights determine the correct characterization of an attorney contingency fee. We therefore hold that *Estate of Clarks* is controlling in the present case, notwithstanding the difference in Michigan's and California's respective attorney's lien laws. In so holding, we will follow our precedent without protracted inquiries into "the intricacies of an attorney's bundle of rights." *Srivastava*, 220 F.3d at 364. The nature of Petitioner's attorney's rights notwithstanding, the facts of this case are within the scope *Estate of Clarks* contemplated: By signing the contingency fee agreement, Petitioner transferred some of the trees from the orchard, rather than simply transferring some of the orchard's fruit. *Estate of Clarks*, 202 F.3d at 858.

We therefore hold that *Estate of Clarks* is not distinguishable based on the distinctions between California's attorney's lien law and Michigan's lien law. Thus, consistent with our prior precedent in *Estate of Clarks*, we hold that the $150,000 Petitioner paid in contingency fees to his attorney is excludable from his gross income. Because the tax court erred in determining that the $150,000 was not excludable, we reverse the tax court as to this issue.

C. Whether the Tax Court Properly Denied Petitioner's 1990 Alimony Deduction Pursuant to the "Duty of Consistency" Doctrine.

Finally, Petitioner appeals the tax court's ruling regarding the deductibility of his alimony payments. At trial, Petitioner had sought to claim as a deduction for the 1990 tax year the $72,013.62 alimony payment he made to Verna Banks. He had argued that although

he took the deduction in 1993 (when the California Superior Court had transferred the funds to Verna), because he had paid the funds into court in 1990 he should have taken the deduction then, pursuant to § 461(f) of the Internal Revenue Code, 26 U.S.C. § 461(f).[8] In denying Petitioner the deduction, the tax court had agreed with Petitioner that an alimony deduction would properly have been taken in 1990. However, the tax court continued, because the Commissioner was now precluded by the § 6501 statute of limitations from adjusting Petitioner's 1993 tax year, the duty of consistency doctrine prevented Petitioner from "taking one position on one tax return and a contrary position on another return for which the limitation period has run." 81 T.C.M. (CCH) 1219, 2001 Tax Ct. Memo LEXIS 68, at *29, 2001 WL 196751. On appeal, Petitioner asserts that this ruling was erroneous as a matter of law. Because the tax court failed to follow our precedent as to the "duty of consistency" rule, we reverse the tax court's ruling with respect to this issue and remand for further consideration.

The "'duty of consistency' rule prevents a taxpayer who has already had the advantage of a past misrepresentation in a year now closed to review by the government from changing his position and, by claiming

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[8] Section 461 provides a deduction for payment of alimony. Specifically, § 461(f) provides that where the alimony payment is a "contested liability," then a transfer of such contested funds is deductible if the following four criteria are met: (1) taxpayer contests an asserted liability, (2) he transfers money or other property to provide for the satisfaction of such liability, (3) the contested nature of the liability still exists after the transfer has been completed, and (4) but for the fact that the asserted liability is contested, a deduction would be allowed in the taxable year of the transfer. 26 U.S.C. § 461(f).

he should have paid more tax before, avoiding the present tax." *Lewis* v. *Comm'r*, 18 F.3d 20, 26 (1st Cir. 1994) (citing *Beltzer* v. *United States*, 495 F.2d 211, 212-13 (8th Cir. 1974)). When this situation arises, "the Commissioner may act as if the previous representation, on which he relied, continued to be true, even if it is not. The taxpayer is estopped to assert the contrary." *Eagan* v. *United States*, 80 F.3d 13, 17 (1st Cir. 1996). The rule's purpose is to "preclude[ ] parties from 'playing fast and loose with the courts' " by taking a position in a given tax year, then taking a contrary position once the statute of limitations has run on that taxable year. *Estate of Ashman* v. *Comm'r*, 231 F.3d 541, 543 (9th Cir. 2000) (quoting *Russell* v. *Rolfs*, 893 F.2d 1033, 1037 (9th Cir. 1990)).

The controlling case on this doctrine is *Crosley Corp.* v. *United States*, 229 F.2d 376 (6th Cir. 1956), which instructs that for the "duty of consistency" doctrine to apply,

> the taxpayer by his conduct must knowingly make a representation or conceal a material fact which he intends or expects will be acted upon by taxing officials in determining his tax, and the true or concealed material facts are unknown to the taxing officials or they lack equal means of knowledge with the taxpayer, and act on his representation or concealment, and to retrace their steps on a different state of facts would cause loss of taxes to the Government. A material factor is the availability of the necessary facts to the parties involved.

Id. at 380-81. Additionally, "[e]stoppel is an affirmative defense and the burden of proof is on the person asserting it." *Id.* at 381 (citing *Helvering* v. *Brooklyn*

City R.R. Co., 72 F.2d 274, 275 (2d Cir. 1934)). In *Crosley*, the taxpayer had erroneously deducted certain expenses over one year, instead of capitalizing them over two years. He therefore filed a claim for refund with respect to the lost year. *Id.* at 378. The district court granted summary judgment in favor of the government based on the duty of consistency doctrine. We reversed, noting that "[t]here was no misrepresentation of any fact by the taxpayer," *id.* at 381, and that, "[u]nder the facts which were known to the Commissioner, or were readily available to him, it was a question of law whether the deduction was properly taken in 1939 or should have been treated as a capital expenditure. A mutual mistake of law on the part of the taxpayer and the Commissioner in treating it as a cost of manufacturing does not create an estoppel." *Id.* We therefore reversed the judgment and remanded for further proceedings. *Id.*[9]

The *Crosley* case controls the present matter and mandates a reversal of the tax court's finding on this issue. We note that the tax court made no finding that Petitioner engaged in a misrepresentation, as *Crosley* requires. Moreover, as Petitioner correctly asserts, his mistake in taking the alimony deduction in 1993 instead of 1990 was a mistake of law, not of fact. Finally, there

[9] Other circuits similarly have required that evidence of a misrepresentation be presented in order for the duty of consistency doctrine to apply. *See, e.g., Eagan*, 80 F.3d at 17 ("The duty of consistency arises when the following elements are present: '(1) a representation or report by the taxpayer; (2) on which the Commissioner has relied; and (3) an attempt by the taxpayer after the statute of limitations has run to change the previous representation or to recharacterize the situation in such a way as to harm the Commissioner.'") (quoting *Herrington* v. *Comm'r*, 854 F.2d 755, 758 (5th Cir. 1988)).

is an open issue as to whether the Commissioner had the same facts on hand as did Petitioner when he took the § 461 deduction in 1993. The tax court made no findings as to these issues. Instead, it declared that because 1993 was a closed tax year and the circumstances satisfied all the elements of the "duty of consistency" rule, Petitioner was precluded from arguing the deductibility of the alimony payment as to the 1990 tax year. However, aside from noting that 1993 was a closed tax year, the court did not address the other elements of the "duty of consistency" rule as articulated in *Crosley*, most particularly our requirement that Petitioner seeks to make a contrary factual representation, as opposed to correcting an earlier erroneous interpretation of the law. Thus, it appears that the tax court was applying a standard other than the standard established by *Crosley*. Application of a rule contrary to our own is erroneous, because the tax court is bound to follow Sixth Circuit precedent. *See Golsen* v. *Comm'r*, 54 T.C. 742, 756-57, 1970 WL 2191 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971). We therefore hold that the tax court must reconsider this issue in light of our precedent in *Crosley*.

The Commissioner invites us to affirm the tax court's denial of a § 461 deduction to Petitioner on the alternative ground that Petitioner failed to establish on the record that his $72,013 payment constituted alimony within the meaning of § 71(b). The Commissioner argues that Petitioner failed to meet the § 71 standard because the record indicates that Petitioner's payments were for Verna's divisible community property share of Petitioner's military retirement benefits, and that this really was "a non-deductible division of community property between the divorced spouses." (Commis-

sioner's Br. at 45.) The Commissioner adds that the $72,013 represented security for satisfaction of the arrears on Verna's payments, but also attorney's fees, which are not deductible.

We decline the Commissioner's invitation. First of all, it does not appear that the Commissioner contested at the tax court trial the issue of whether Petitioner's $72,013 payment to his former spouse constituted alimony within the meaning of § 71. Moreover, although the tax court indicated that Petitioner should have taken the § 461 deduction in 1990 as opposed to 1993, the tax court did not elaborate on the analysis, and in particular the tax court offered no detailed discussion as to whether the $72,013 payment constituted alimony within the meaning of § 71, as required by § 461. Therefore, while the Commissioner may be correct as to the proper

characterization of the $72,013 payment, it is not clear on the present record whether the tax court made a specific factual finding as to whether Petitioner's $72,013 payment constituted § 71 alimony, or whether the court was assuming arguendo that the $72,013 payment constituted alimony for purposes of rejecting Petitioner's argument based on the "duty of consistency" doctrine. Further, it is not clear on this record whether such a finding was erroneous, if indeed the tax court made such a finding. We are not inclined, on this limited record, to determine the character of the $72,013 payment or the propriety of a § 461 deduction (notwithstanding the "duty of consistency" doctrine) in reviewing the tax court's ultimate resolution of the issue.

Because the tax court did not follow our precedent in *Crosley* in determining that the doctrine of consistency

applies, we reverse the tax court's denial of the § 461 deduction Petitioner seeks. However, on remand, the tax court, if it deems appropriate, may revisit the issue of whether the $72,013 payment constituted alimony within the meaning of § 71. In making this determination, the court may consider any new evidence the Commissioner or Petitioner wishes to present on the issue.

IV. CONCLUSION

For the foregoing reasons, we **AFFIRM** the tax court's decision that Petitioner's California federal court suit settlement proceeds were not excludable from gross income under 26 U.S.C. § 104. However, we **REVERSE** the tax court's determination that the contingency fees Petitioner paid to his attorney constituted taxable income, and we **REVERSE** the tax court's ruling that Petitioner could not deduct his alimony payments for the 1990 taxable year based on the "duty of consistency" doctrine. We **REMAND** this case to the tax court for further consideration consistent with this opinion.

MOORE, Circuit Judge, concurring in part and dissenting in part.

Although I agree with much of the majority's thoughtful opinion, I write separately to express my disagreement regarding the contingency-fee issue.

As the majority holds, we are bound by our circuit's recent decision in *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2000), which held that the lawyer's contingency fee operated as a lien on the client's recovery that under Michigan law transferred part of the ownership of the client's claim to the attorney, such that the client never realized income on the con-

tingency-fee part of the judgment. We are dealing here, however, not with Michigan law but with California law regarding the characterization of the lawyer's contingency-fee interest in taxpayer Banks's employment-related claim. California's law has been authoritatively and persuasively construed by a panel of the Ninth Circuit in *Benci-Woodward* v. *Commissioner*, 219 F.3d 941 (9th Cir. 2000), which held that, "[u]nder California law, an attorney lien does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients." *Id.* at 943 (relying on *Isrin* v. *Superior Court*, 63 Cal.2d 153, 45 Cal. Rptr. 320, 403 P.2d 728, 732, 733 (1965)). California law, as explained by the California Supreme Court and the Ninth Circuit, clearly treats the attorney's contingency-fee contract as simply a security interest and not as an ownership interest. Thus I would affirm the Tax Court's ruling here that the proceeds the taxpayer paid to his attorney as a contingency fee should be included in the taxpayer's income. *See also Srivastava* v. *Commissioner*, 220 F.3d 353, 367-69 (5th Cir. 2000) (Dennis, J., dissenting).

Regarding the issue of the deductibility of the taxpayer's payments to his ex-wife and the duty of consistency, I do not disagree with the majority's assessment that the Tax Court did not appear to apply our half-century-old case, *Crosley Corp.* v. *United States*, 229 F.2d 376 (6th Cir. 1956), and that the Tax Court did not appear to make any relevant factual findings. Therefore I do not disagree with remanding this issue to the Tax Court for further proceedings. I note that this case seems to me to be one where the duty of consistency applies, because the taxpayer has unique

knowledge regarding the nature and timing of his payments for his ex-wife, such that he should not be able to take one position on one tax return and a diametrically opposite position on another return on which the statute of limitations has run against the government. I suggest that in revisiting this issue, the Tax Court is free to determine whether there was a representation by the taxpayer as well as to evaluate the other requirements that comprise our version of the duty of consistency. I agree with the majority that on remand the Tax Court also may address the underlying question whether the payment even constituted § 71 alimony at all.

Finally, I concur fully in the majority's determinations that the taxpayer's characterization of the settlement proceeds as payment for personal injuries is worth no weight and that the Tax Court properly determined that no portion of the settlement amount was attributable to personal injuries.

APPENDIX B

UNITED STATES TAX COURT

No. 18096-97, 18097-97

JOHN W. BANKS, II, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

JOHN W. BANKS, II, AND NORA J. BANKS, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Feb. 28, 2001

MEMORANDUM FINDINGS OF FACT AND OPINION

LARO, J.

The notice of deficiency in docket No. 18096-97 reflects deficiencies of $11,707, $101,168, and $8,772 in the 1988, 1990, and 1991 Federal income tax liabilities, respectively, of John W. Banks, II (petitioner). The notice of deficiency in docket No. 18097-97 reflects a deficiency of $24,654 in the 1992 Federal income tax liability of petitioner and Nora J. Banks. By way of an amendment to the answer in docket no. 18096-97,

respondent disallowed deductions of $108,306 including a net operating loss (NOL) carryover of $101,365 that petitioner applied to 1988 and alleged a resulting additional deficiency of $10,596 for that year. Respondent also alleged in the amended answer that petitioner was liable for a $5,576 addition to his 1988 tax under Section 6651(a)(1).[1]

Following the parties' concessions, including one by respondent that Nora J. Banks has no deficiency for 1992 because she qualifies for relief from joint liability on a joint return under section 6015, we must decide:

1. Whether petitioner's gross income includes any of the settlement proceeds which he received from an action based, in part, on Title VII of the Civil Rights Act of 1964 (title VII), Pub. L. 88-352, 78 Stat. 253;

2. Whether petitioner may deduct an NOL in any of the subject years;

3. Whether petitioner's 1992 gross income includes the items of income discussed below;

4. Whether petitioner is entitled to the deductions described below;

5. Whether petitioner is liable for the addition to tax determined by respondent under Section 6651(a)(1); and

6. Whether petitioner is entitled to relief from joint liability on a joint return under Section 6015(c) for 1992.

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[1] Unless otherwise indicated, section references are to the Internal Revenue Code in effect for the years in issue. Rule references are to the Tax Court Rules of Practice and Procedure.

FINDINGS OF FACT

Petitioner resided in Benton Harbor, Michigan, when the petitions in these cases were filed. From 1972 through July 14, 1986, petitioner was employed as an educational consultant by the California Department of Education (DOE). The DOE terminated petitioner's employment effective July 14, 1986. Petitioner's termination was upheld on appeal.

In 1983, petitioner filed a charge against the DOE with the Equal Employment Opportunity Commission. By letter dated April 20, 1984, that commission notified petitioner that he had the right to sue the DOE under title VII. This letter is a jurisdictional prerequisite to filing suit in Federal District Court under title VII.

On June 28, 1984, petitioner filed a complaint in the United States District Court for the Eastern District of California (District Court) against the DOE and others (Banks I). The complaint alleged violations under title VII and 42 U.S.C. sec.1981 (1982). Petitioner filed two amended complaints, the last of which (second amended complaint) was filed by the District Court on January 15, 1985. The second amended complaint alleged unlawful discrimination in employment practices under title VII and 42 U.S.C. secs.1981 and 1983 (1986). The second amended complaint also alleged claims arising under California law, including claims of intentional infliction of emotional distress and slander. The second amended complaint sought the following relief:

ON THE FIRST COUNT

1. For general damages for violation of plaintiff's constitutional rights, harassment, humiliation, and embarrassment in an amount subject to proof;

2. For medical and hospital expenses in an amount subject to proof;

3. For future medical and hospital expenses in an amount subject to proof;

4. For punitive and exemplary damages in an amount determined by the trier of fact;

5. For reasonable attorneys fees incurred in the prosecution of this action;

6. For costs of suit herein incurred;

7. For such other and further relief that the Court may deem just and proper.

ON THE SECOND AND THIRD COUNTS

1. An order requiring defendants and each of them to promote plaintiff to the position of Administrator II, in the State Department of Education;

2. An order requiring defendants, and each of them, to make whole by appropriate back pay and related employee benefits, and damages to plaintiff because of being adversely affected by discrimination on account of race in the part of defendants;

3. For general damages to compensate plaintiff for the harm, humiliation, and discrimination suffered in an amount according to proof;

4. An order granting plaintiff a preliminary and permanent injunction restraining defendants, their agents, successors, employees, attorneys, and all others acting in concert with defendants or under

defendants' direction from discriminating on the basis of race or color, and requiring them to undertake remedial action to eradicate any effects of past discrimination;

5. An order awarding reasonable attorneys' fees and costs; and,

6. An order granting such further relief as the court deems proper.

ON THE FOURTH COUNT

1. For general damages in the sum of $1,000,000.00 (One Million Dollars);

2. For medical, hospital and related expenses according to proof;

3. For lost earnings and losses sustained in the sum of $1,000,000.00 (One Million Dollars);

4. For exemplary and punitive damages in the sum of $1,000,000.00 (One Million Dollars);

5. For costs of suit herein incurred:

6. For such other and further relief that the court may deem just and proper.

ON THE FIFTH COUNT

1. For general damages to plaintiff's reputation in the sum of $1,000,000.00 (One Million Dollars);

2. For special damages for lost profits and losses sustained in the sum of $4,500,000.00 ($4.5 Million);

3. For medical, hospital, and related expenses according to proof;

4. For exemplary and punitive damages in the sum of $1,000,000.00 (One Million Dollars);

5. For costs of suit herein incurred;

6. For such other and further relief that the Court may deem just and proper.

ON THE SIXTH COUNT

1. For general damages to plaintiff's reputation in the sum of $1,000,000.00 (One Million Dollars);

2. For special damages for lost profits and losses sustained [in] the sum of $4,500,000.00 ($4.5 Million);

3. For medical, hospital, and related expenses according to proof;

4. For exemplary and punitive damages in the sum of $1,000,000.00 (One Million Dollars);

5. For costs of suit herein incurred;

6. For such other and further relief that the Court may deem just and proper.

On November 25, 1987, petitioner filed in the District Court a second lawsuit (Banks II) against the DOE and others. Petitioner alleged in Banks II violations under title VII and 42 U.S.C. sec.1983 (1982). Banks II was consolidated with Banks I (Banks cases) on January 19, 1989.

On September 22, 1989, the District Court issued a final pretrial conference order in the Banks cases. The order states, under the heading "RELIEF SOUGHT", that "Plaintiff seeks only reinstatement, back pay, and attorneys' fees." The order also states, under the heading "ABANDONED ISSUES", that "Plaintiff has abandoned all claims for damages relative to state tort claims, including a claim for intentional and negligent imposition of emotional distress, tortious interference with business relations, and defamation."

Petitioner and the DOE settled the Banks cases before judgment and reflected their settlement in a settlement agreement dated May 30, 1990. The settlement agreement provides in relevant part that "Plaintiff characterizes this payment of $464,000.00 as a payment for personal injury damages suffered after plaintiff's discharge on July 14, 1986."

On July 29, 1986, petitioner filed a voluntary petition in the United States Bankruptcy Court in Sacramento, California, under chapter 7 of the United States Bankruptcy Code. When he did so, petitioner owned an interest in a fully developed subdivision known as Frenchtown Hills Subdivision (Frenchtown Hills) and a 15-percent interest in a real estate partnership known as Auburn Bluffs, Ltd. (Auburn Bluffs). Auburn Bluffs' primary asset was an incomplete subdivision that was not ready to be sold as individual lots. Petitioner's interests in Frenchtown Hills and Auburn Bluffs became part of his bankruptcy estate (estate).

On August 8, 1986, the bankruptcy court appointed a trustee, John Roberts, to administer the estate. Mr. Roberts decided not to have the estate develop either Frenchtown Hills or the Auburn Bluffs property. Mr. Roberts asked the bankruptcy court on August 15,

1986, to approve the estate's employment of a firm to market and sell Frenchtown Hills.

Each lot in Frenchtown Hills was sold during the estate's administration at its fair market value. Petitioner did not object to those values. The estate was unable to sell petitioner's Auburn Bluffs' partnership interest. Instead, the trustee reached a stipulated settlement with Auburn Bluffs' partners. Petitioner paid $10,000 to the estate for the claim against the DOE.

At the request of Mr. Roberts, Michael Owen, a certified public accountant, prepared fiduciary income tax returns for each of the estate's taxable years ended June 30, 1986 through 1990, and for a short period ended on December 31, 1990. Mr. Owen obtained from Mr. Roberts, petitioner, and/or third parties information as to the bases of property sold during the relevant years. Mr. Roberts filed with the Commissioner each of the returns prepared by Mr. Owens. The Commissioner destroyed those returns. Mr. Roberts retained unsigned copies of the returns.

On April 19, 1993, Mr. Roberts filed his final report and proposed distribution with the bankruptcy court as to the estate. The purpose of that filing was to put all interested parties, including creditors and the debtor, on notice as to his proposal to wind up the estate. On July 19, 1993, the bankruptcy court entered an order approving Mr. Roberts' final report and payment of dividends. On October 29, 1993, Mr. Roberts filed his report of final account and request for closing and discharge of trustee. In 1993, in winding up the estate, the estate made its final distributions to creditors and distributed to petitioner, the debtor, $3,700.

On December 29, 1993, the bankruptcy court ordered the estate closed. The estate did not disclaim any NOLs or any other property, except for some raw land in Arkansas that was abandoned by the trustee. The closing of the estate was delayed because petitioner sued Mr. Roberts, the trustee.

On his 1985 Federal income tax return, petitioner claimed a $61,592 loss from the sale of subdivision lots in Frenchtown Hills and a $48,589 loss from various Auburn Bluffs partnership interests. On his 1986 return, petitioner claimed a $53,192 loss from the sale of subdivision lots in Frenchtown Hills and a $90,036 loss from various Auburn Bluffs partnership interests. On his 1987 return, petitioner claimed a $17,100 loss from the sale of subdivision lots in Frenchtown Hills, a $9,666 loss from various Auburn Bluffs partnership interests, and a $110,617 deduction for an NOL carryover from 1986.

On or about January 30, 1991, petitioner filed an amended return for 1987 in which he increased by $47,788 the cost of goods sold as to his Frenchtown Hills interest. The increase to the cost of goods sold increased his claimed loss from $17,100 to $64,888 and his claimed remaining NOL carryover to $146,458. On his 1988 return, petitioner claimed a $101,365 deduction for an NOL carryover; he did not report an NOL; nor did he report any losses from Frenchtown Hills or Auburn Bluffs. On his 1988 return, petitioner reported a net profit of $62,304 from the sale of lots in the Frenchtown Hills subdivision.

Shortly before this Court's trial of this case, petitioner raised as an issue whether he was entitled to deduct $450,000 as a bad debt or NOL on account of Mr. Roberts' abandonment of a judgment against Milton

McGhee. Petitioner won a $483,600 judgment against Mr. McGhee in 1984, which became property of the bankruptcy estate. Petitioner abandoned his claim for a bad debt deduction at trial. Petitioner did not inform William Wise, his attorney in this proceeding, that he had deducted the McGhee bad debt on his 1997 return.

In his petitions and at trial, Mr. Banks asserted that he was entitled to additional losses from Frenchtown Hills, losses which he alleges were abandoned by Mr. Roberts and are deductible in 1990. Mr. Banks deducted $1,060,122 on his 1994 return for "involuntary conversion—French Town Hills—106122 near Shingle Springs, CA Loss taken due to court proceedings—details in taxpayers file." Petitioner did not inform Mr. Wise that petitioner had deducted the Frenchtown Hills loss on his 1994 return.

On his 1991 tax return, petitioner showed an NOL carryover of $64,445, which he used to offset $50,843 in income. On his 1992 tax return, petitioner showed an NOL carryover of $182,510, which was used to offset $142,022 in income. In 1988, petitioner was aware he had gross income, including $9,906 in wages, $17,088 in retirement pay, $1,552 in unemployment compensation, and $1,838 in commissions. Not including net profit in the amount of $62,304 reported on Schedule C and shown on line 12, petitioner had gross income in 1988 in the amount of $30,384. Petitioner did not sign his 1988 tax return until March 7, 1990.

OPINION

1. *Taxability of Settlement Proceeds*

We must decide whether petitioner received any of the settlement proceeds on account of a personal injury. To the extent that he did, the funds are excludable from his gross income. See sec. 104(a)(2). To the extent that he did not, the funds are includable in his gross income. See sec. 61(a). Because respondent determined that none of the proceeds are excludable from petitioner's gross income under Section 104(a)(2), petitioner must prove otherwise. See Rule 142(a); *Welch* v. *Helvering*, 290 U.S. 111, 115, 54 S. Ct. 8, 78 L.Ed. 212 (1933); *Robinson* v. *Commissioner*, 102 T.C. 116, 124, 1994 WL 26303 (1994), *aff'd* in part, revd. in part on an issue not relevant herein and remanded 70 F.3d 34 (5th Cir. 1995).

For 1990, Section 104(a)(2) excludes from gross income "the amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness". Damage recoveries fall within this provision to the extent that: (1) The cause of action giving rise to the damages is based upon tort or tort type rights and (2) the damages are received on account of personal injuries or sickness. See *Commissioner* v. *Schleier*, 515 U.S. 323, 336-337, 115 S. Ct. 2159, 132 L.Ed.2d 294 (1995). For the taxable year under consideration, personal injuries included both physical and nonphysical injuries. *See id.* at 329 n. 4.

The nature of the claim underlying a damage award, rather than the validity of the claim, determines whether damages meet the two-part *Schleier* test. See *United States* v. *Burke*, 504 U.S. 229, 237, 112 S. Ct.

1867, 119 L.Ed.2d 34 (1992); *Robinson* v. *Commissioner*, *supra* at 125-126. Ascertaining the nature of the claim is a factual determination that is generally made by reference to the settlement agreement, in light of the facts and circumstances surrounding it. Key to this determination is the "intent of the payor" in making the payment. *Knuckles* v. *Commissioner*, 349 F.2d 610, 613 (10th Cir. 1965), affg. T.C. Memo.1964-33; *Agar* v. *Commissioner*, 290 F.2d 283, 284 (2d Cir. 1961), affg. per curiam T.C. Memo.1960-21; *Seay* v. *Commissioner*, 58 T.C. 32, 37, 1972 WL 2542 (1972). We ask ourselves: "In lieu of what were the damages awarded?" See *Robinson* v. *Commissioner*, *supra* at 126, and the cases cited therein. Although the payee's belief is relevant to this inquiry, the ultimate character of the payment rests on the payor's dominant reason for making the payment. See *Agar* v. *Commissioner*, 290 F.2d at 284; *Fono* v. *Commissioner*, 79 T.C. 680, 1982 WL 11175 (1982), *aff'd* without opinion 749 F.2d 37 (9th Cir. 1984). A payor's intent may sometimes be found in the characterization of the payment in a settlement agreement, but such a characterization is not always dispositive. Such a characterization is not dispositive, for example, when the record proves the characterization was not the product of bona fide adversarial negotiations. See *Bagley* v. *Commissioner*, 105 T.C. 396, 406, 1995 WL 730447 (1995); *Robinson* v. *Commissioner*, *supra*; *Threlkeld* v. *Commissioner*, 87 T.C. 1294, 1306-1307, 1986 WL 22061 (1986), *aff'd* 848 F.2d 81 (6th Cir. 1988); see also *Knuckles* v. *Commissioner*, *supra* at 613; *Eisler* v. *Commissioner*, 59 T.C. 634, 640, 1973 WL 2521 (1973).

Following his abandonment in the District Court of his State law tort claims, petitioner's causes of action in

the Banks cases were limited to alleged violations under title VII and 42 U.S.C. secs. 1981 and 1983 (1986). Petitioner settled those claims before the enactment and effective date of the Civil Rights Act of 1991, Pub. L. 102-166, 105 Stat. 1071. As to pre-1991 title VII, the Supreme Court has concluded:

> we cannot say that a statute such as Title VII, whose sole remedial focus is the award of back wages, redresses a tort-like personal injury within the meaning of § 104(a)(2) and the applicable regulations.
>
> Accordingly, we hold that the backpay awards received by respondents in settlement of their Title VII claims are not excludable from gross income as "damages received . . . on account of personal injuries" under § 104(a)(2). [*United States* v. *Burke*, 504 U.S. 229, 241-242, 112 S. Ct. 1867, 119 L.Ed.2d 34; fn. refs. omitted.]

On the basis of *United States* v. *Burke*, we hold that none of the settlement proceeds attributable to petitioner's pre-1991 title VII claim are excludable from income pursuant to Section 104(a)(2).

We turn next to the portion (if any) of the settlement amount that is attributable to petitioner's remaining claims under 42 U.S.C. secs. 1981 and 1983 (1986).

The Supreme Court in *United States* v. *Burke*, *supra* at 240, noted: "Rev. Stat. § 1977, 42 U.S.C. § 1981, permits victims of race-based employment discrimination to obtain a jury trial at which 'both equitable and legal relief, including compensatory and, under certain circumstances, punitive damages' may be awarded."

The court went on to say unlike title VII actions such actions were tortlike.

With the enactment of 42 U.S.C. sec.1983, the Congress created a "federal cause of action unknown at common law, [for] the deprivation of any rights, privileges, or immunities secured by the Constitution and laws [of the United States.] * * * In the broad sense, every cause of action under § 1983 which is well-founded results from 'personal injuries'." *Almond* v. *Kent*, 459 F.2d 200, 204 (4th Cir. 1972). The Supreme Court has declared that 42 U.S .C. sec. 1983 was intended to create a species of tort liability. See *Carey* v. *Piphus*, 435 U.S. 247, 253, 98 S. Ct. 1042, 55 L.Ed.2d 252 (1978). This Court has held that damages received in a suit under 42 U.S.C. sec. 1983 for a violation of a first amendment right were excludable under Section 104(a)(2). See *Bent* v. *Commissioner*, 87 T.C. 236, 1986 WL 22165 (1986), *aff'd.* 835 F.2d 67 (3d Cir. 1987).

However, in the instant case the pretrial order explicitly limits the remedies sought by petitioner: "Plaintiff seeks only reinstatement, back pay, and attorneys' fees". These remedies are available under title VII. The remedies do not include both equitable and legal relief, including compensatory and punitive damages allowable under 42 U.S.C. secs. 1981 or 1983. On the basis of the pretrial order, we find that petitioner had, at the time of settlement, abandoned his claims under 42 U.S.C. secs. 1981 and 1983. Consequently none of the settlement amount is attributable to a claim of personal injury.

Although the settlement agreement recites petitioner's desired characterization of the entire settlement proceeds as "payment for personal injury damages suffered after plaintiff's discharge on July 14,

1986", we, unlike petitioner, do not accept that statement as a binding characterization of the settlement proceeds.

In *Robinson* v. *Commissioner*, 102 T.C. 116, 1994 WL 26303 (1994), the taxpayers sued a State bank for failing to release a lien on their property. After the jury returned a verdict in their favor for approximately $60 million, including $6 million for lost profits, $1.5 million for mental anguish, and $50 million in punitive damages, the parties to that proceeding settled. In the final judgment reflecting the settlement, which was drafted by the parties and signed by the trial judge, 95 percent of the settlement proceeds was allocated to mental anguish and 5 percent was allocated to lost profits. We held that this allocation did not control the taxability of the proceeds to the taxpayers. We noted that the allocation was "uncontested, nonadversarial, and entirely tax motivated", and that it did not accurately "reflect the realities of * * * [the parties'] settlement." *Id.* at 129; accord *Hess* v. *Commissioner*, T.C. Memo. 1998-240.

The same is true here. While the underlying litigation was certainly adversarial, the parties were no longer adversaries after they agreed on a settlement in principle. Petitioner wanted the settlement payment connected to a tortlike personal injury so that he could maximize his recovery by avoiding taxes on his recovery. The DOE, on the other hand, did not care whether the settlement proceeds were allocated to tortlike personal injury damages vis-a-vis other damages. The DOE's dominant concern was that all of petitioner's claims be settled. The DOE, in effect, gave petitioner the green light to state in the settlement agreement his opinion as to the characterization of the

settlement proceeds. Petitioner and the DOE did not prepare the settlement agreement by assessing the damages of the lawsuit and allocating petitioner's recovery accordingly.

In a setting such as this, where the parties to a settlement agreement fail to reflect accurately their agreement in a written document, we need not accept the characterization of one of the parties. That petitioner may have wanted the payment to be characterized as compensation for a tortlike personal injury does not govern the taxation of the payment for purposes of Section 104(a)(2). The key to the payment's taxability, as discussed above, turns on the payor's intent. That intent, we find, is found in the District Court's pretrial order. Pretrial orders, unless modified, control the subsequent course of a lawsuit, see Fed. R. Civ. P. 16(e), and we find nothing in the record to indicate that the District Court's pretrial order was not in effect when the case settled. As the District Court's pretrial order states clearly: "Plaintiff seeks only reinstatement, back pay, and attorneys' fees" and "Plaintiff has abandoned all claims for damage relative to state tort claims, including a claim for intentional and negligent imposition of emotional distress, tortious interference with business relations, and defamation." Because petitioner was not seeking personal injury damages at the time of settlement, we hold for respondent on this issue. None of the settlement proceeds are excludable under Section 104(a)(2).

Petitioner also contends that $150,000 of the proceeds that he paid to his attorney as a contingent fee is excludable from his gross income under *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959), revg. in part and affg. in part 28 T.C. 947, 1957 WL 1117 (1957)

(*Cotnam*), and its progeny. *Cotnam* excluded from a taxpayer's gross income the portion of a damage award paid to the taxpayer's attorney under a contingent fee arrangement.

We disagree that the holding of the Court of Appeals in *Cotnam* or its progeny control this case. In *Kenseth* v. *Commissioner*, 114 T.C. 399, 412, 2000 WL 669977 (2000), we reconsidered our view of the *Cotnam* holding in light of the views as to that holding expressed by various Courts of Appeals, including the Court of Appeals for the Sixth Circuit Court of Appeals in *Estate of Clarks ex rel. Brisco-Whitter* v. *United States*, 202 F.3d 854 (6th Cir. 2000). We concluded in *Kenseth* v. *Commissioner*, *supra* at 412 that we respectfully continue to believe that *Cotnam* was wrongly decided and that we would "adhere to our holding * * * [contrary to *Cotnam*] that contingent fee agreements * * * come within the ambit of the assignment of income doctrine and do not serve * * * to exclude the fee from the assignor's gross income."

The Court of Appeals for the Sixth Circuit, the court to which an appeal of this case lies, agrees with the holding in *Cotnam* that excludes from a taxpayer's gross income the portion of a damage award paid to the taxpayer's attorney under a contingent fee arrangement. In *Estate of Clarks ex rel. Brisco-Whitter* v. *United States*, *supra* at 856, the Court of Appeals for the Sixth Circuit interpreted applicable State (Michigan) law to operate more or less the same way as the applicable State (Alabama) law in *Cotnam*. The court held that a portion of the contingent fee paid to the estate's attorneys was not includable in the estate's income. The court rejected the proposition that the assignment of income doctrine enunciated in *Lucas* v. *Earl*, 281 U.S. 111, 50 S. Ct. 241, 74 L.Ed. 731 (1930), is applicable to such contingent fee agreements.

Under our so-called *Golsen* doctrine, see *Golsen* v. *Commissioner*, 54 T.C. 742, 756-757, 1970 WL 2191 (1970), *aff'd* 445 F.2d 985 (10th Cir. 1971), we follow the holding of a Court of Appeals to which a case is appealable where that holding is squarely on point. For the reasons stated by the Court of Appeals for the Ninth Circuit in *Benci-Woodward* v. *Commissioner*, 219 F.3d 941, 943 (9th Cir. 2000), affg. T.C. Memo.1998-395, and *Coady* v. *Commissioner*, 213 F.3d 1187 (9th Cir. 2000), affg. T.C. Memo.1998-291, we conclude, as did the Court of Appeals in those cases, that *Estate of Clarks ex rel. Brisco-Whitter* v. *United States*, *supra*, is distinguishable. Whereas the applicable State law in *Estate of Clarks ex rel. Brisco-Whitter* v. *United States*, *supra*, was that of Michigan, the applicable State law here is that of California. Under California law, an attorney's lien does not confer any ownership interest upon an attorney or grant an attorney any right and power over the suits, judgments, or decrees of their clients. As explained by the California Supreme Court, in interpreting its State law:

> in whatever terms one characterizes an attorney's lien under a contingent fee contract, it is no more than a security interest in the proceeds of the litigation * * * While there is occasional language in cases to the effect that the attorney also becomes the equitable owner of a share of the client's cause of action, we stated more accurately in *Fifield Manor* v. *Finston*, 54 Cal.2d 632, 641, 7 Cal. Rptr. 377, 354 P.2d 1073 (1960), * * * that contingent fee contracts "do not operate to transfer a part of the

cause of action to the attorney but only give him a lien upon his client's recovery."

* * * * *

[t]he conclusion emerges that in litigation an attorney conducts for a client he acquires no more than a professional interest. To hold that a contingent fee contract or any "assignment" or "lien" created thereby gives the attorney the beneficial rights of a real party in interest, with the concomitant personal responsibility of financing the litigation, would be to demean his profession and distort the purpose of the various acceptable methods of securing his fee. * * * [*Isrin* v. Superior Court, 63 Cal. 2d 153, 45 Cal. Rptr. 320, 403 P.2d 728, 732, 733 (Cal. 1965).]

See Benci-Woodward v. Commissioner, supra, where the Court of Appeals for the Ninth Circuit held that California law did not operate to exclude a contingent fee payment from the taxpayers' gross income.

On the basis of California law, as interpreted in *Isrin* v. *Superior Court*, *supra*, and *Benci-Woodward* v. *Commissioner*, *supra*, we hold that all of the settlement proceeds, less the $10,000 paid to the estate for the cause of action, must be included in petitioner's gross income in the year received.

2. *NOL's*

Section 1398 applies to this case because petitioner is an individual who was a debtor in a proceeding under chapter 7 of the U .S. Bankruptcy Code. See sec. 1398(a). Section 1398 provides that a debtor's bankruptcy estate succeeds to the debtor's NOL carryovers

and that the debtor succeeds to the NOL carryovers which remain when the bankruptcy estate is terminated. See sec. 1398(g), (i).

Petitioner's estate was created on July 29, 1986, upon his filing of his petition with the bankruptcy court. See 11 U.S.C. sec. 303 (1978). Because the estate did not terminate until it closed on December 29, 1993, see 11 U.S.C. sec. 346(i)(2) (1976); see also *Firsdon* v. *United States*, 95 F.3d 444, 446 (6th Cir. 1996); *McGuril* v. *Commissioner*, T.C. Memo.1999-21; *Beery* v. *Commissioner*, T.C. Memo. 1996-464, we hold that he was not entitled to claim personally in the subject years a deduction for an NOL that arose prior to the estate's commencement; see sec. 1398(g); see also *Kahle* v. *Commissioner*, T.C. Memo.1997-91. (NOL's determined as of the first day of the debtor's taxable year in which the bankruptcy case commences become part of the estate and no longer belong to the debtor-taxpayer).

3. *Income Items*

Items of gross income realized from the assets of a bankruptcy estate after the commencement of a bankruptcy action are generally included in the gross income of the bankruptcy estate rather than the gross income of the debtor. See sec. 1398(e)(1) and (2).

Petitioner's 1988 individual income tax return shows a net profit of $62,304 from the "Sales—subdivision lots French Hills". The Frenchtown Hills subdivision was part of the estate in 1988, and the related sales income was includable in the estate's gross income. We understand Mr. Roberts to have reported that sales income on the estate's 1988 fiduciary return. Accordingly, the

$62,304 is excluded from petitioner's gross income for 1988.

Petitioner also seeks to exclude the following sums of interest income: $6,126 (unreported), $5,847 (reported), and $5,196 (reported) for 1992; and $12,412 and $6,113 (both reported) for 1991. Petitioner argues that these amounts were reported on the estate's tax returns. We disagree. The last return that the estate filed was for 1990. We conclude that all of the interest income, both reported and unreported, was includable in petitioner's gross income for the respective years in which received.

4. *Deductions*

Petitioner seeks deductions for a 1990 or 1991 capital loss, attorney's fees in excess of the $150,000 allowed by the respondent, amounts repaid to his Public Employees Retirement System (PERS) account, amounts allegedly deducted from employee compensation paid to him in an earlier year, and alimony allegedly paid to his ex-wife, Verna Jo Banks. Petitioner has not proved his entitlement to any of these deductions. See Rule 142(a).

As to the capital loss, the record does not support petitioner's claim that he is entitled to deduct such a loss in either 1990 or 1991. The same is true as to the excess attorney's fees. The only evidence petitioner presented to substantiate his claim to a deduction for attorney's fees paid in 1990 (over and above the $150,000 mentioned above) was his uncorroborated testimony that he paid $45,000 of the settlement proceeds to another attorney in the lawsuits. We find that testimony unpersuasive and self-serving. We also find no substantiation (nor perceive any rationale) for petitioner's claim to a $14,000 deduction for alleged loan

repayments to his PERS account, or to a $14,000 deduction for alleged withholding from his pay for his wrongful use of his employer's property.

As to the alimony, petitioner claims a deduction of $72,013.62 for alimony paid to his first wife. Petitioner paid that sum into court in 1990 in connection with a judgment rendered in his divorce proceeding with Vera Banks. The court transferred the funds to Vera Banks in 1993. Petitioner concedes that he deducted this alimony for 1993 but claims that section 461(f) provides that the alimony was deductible in 1990.

While we agree that the deduction would otherwise be allowed in 1990, see sec. 461(f), the circumstances of this case prohibit petitioner from claiming the deduction in that year. The "duty of consistency", sometimes referred to as quasi-estoppel, is an equitable doctrine that Federal courts apply in appropriate cases to prevent unfair avoidance of tax. *Beltzer* v. *United States*, 495 F.2d 211, 212 (8th Cir. 1974); *Cluck* v. *Commissioner*, 105 T.C. 324, 1995 WL 634447 (1995); *LeFever* v. *Commissioner*, 103 T.C. 525, 1994 WL 585354 (1994), *aff'd* 100 F.3d 778 (10th Cir. 1996). The doctrine "is based on the theory that the taxpayer owes the Commissioner the duty to be consistent in the tax treatment of items and will not be permitted to benefit from the taxpayer's own prior error or omission." *Cluck* v. *Commissioner*, *supra* at 331. It prevents a taxpayer from taking one position on one tax return and a contrary position on another return for which the limitation period has run. See *id.* If the duty of consistency applies, a taxpayer who is gaining Federal tax benefits on the basis of a representation is estopped from taking a contrary return position in order to avoid taxes. See *id.*

Because petitioner's 1993 taxable year is a closed year, and because all of the elements of the doctrine are satisfied, we hold that petitioner is bound by the duty of consistency and prohibited from arguing that the alimony was deductible in 1990, rather than in 1993 as he originally reported.

5. *Addition to Tax*

Respondent amended his answer to seek an addition to tax for petitioner's failure to file timely his 1988 Federal income tax return. Respondent has the burden of proof on this issue. See Rule 142(a). Section 6651(a)(1) imposes an addition to tax equal to 5 percent per month of the underpayment up to a maximum of 25 percent for untimely filed returns. This addition to tax is not imposed if the failure to file timely was due to reasonable cause and not due to willful neglect. Petitioner's 1988 Federal income tax return was due on April 15, 1989. Petitioner signed his 1988 Federal income tax return on March 7, 1990, and did not file it until September 27, 1990. The record is void of any explicit explanation as to why petitioner failed to file his return in a timely manner or whether there was a reasonable cause for the untimely filing. We find that respondent has not discharged his burden, and therefore, we do not sustain respondent's determination that petitioner is liable for the addition to tax under Section 6651(a).

6. *Relief From Joint Liability on a Joint Return*

On March 13, 2000, petitioner filed with the Commissioner a Form 8857, Request for Innocent Spouse Relief, electing the application of Section 6015(c) to 1992 and requesting that any deficiency owed by him be computed under the provisions of Section 6015(d). Petitioner argues that he "was divorced from Nora Banks and his election was timely and made in the circumstances contemplated by the statute." Respondent denied petitioner's request.

The items that gave rise to the deficiency, *i.e.*, the reported NOL carryforward and the omitted interest, are all items attributable to petitioner. Section 6015(c) provides relief only to the spouse to whom such items are not attributable. See also sec. 6015(b). We hold that petitioner is not entitled to relief under Section 6015.

All arguments not herein addressed have been rejected as irrelevant or without merit. To reflect the foregoing,

Decisions will be entered under Rule 155.

(2)

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No. 03-892

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

JOHN W. BANKS, II,

Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

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QUESTION PRESENTED

Whether the court of appeals below correctly determined that the anticipatory assignment of income doctrine does not require an employment discrimination plaintiff to include in his or her gross income the portion of a settlement or judgment paid to his or her attorney under a contingent fee agreement.

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a–33a) is reported at 345 F.3d 373. The opinion of the Tax Court (Pet. App. 34a-57a) is a memorandum decision, T.C. Memo. 2001-48 (Feb. 28, 2001), unofficially reported at 81 T.C.M. (CCH) 1219.

JURISDICTION

The judgment of the court of appeals was filed on September 30, 2003. The petition for certiorari was filed on December 19, 2003. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATEMENT

1. Respondent John W. Banks, II, filed a federal civil rights employment discrimination lawsuit against his former employer, the California Department of Education, in 1984. Mr. Banks filed two amended complaints, and a second lawsuit. The two lawsuits were consolidated. Shortly after trial began in 1990, Mr. Banks settled all of his claims for $464,000. Pursuant to a contingent fee contract Mr. Banks entered into with his attorney before the commencement of the lawsuit, $150,000 of the settlement amount was paid by the defendant to Mr. Banks's attorney. Pet. App. 1a-5a.

2. In 1997, the Commissioner issued a Notice of Deficiency to Mr. Banks for the 1990 tax year. Pursuant to the Notice, the portion of the settlement proceeds paid to Mr. Banks's attorney under the contingent fee agreement constituted taxable income to Mr. Banks. Mr. Banks filed a timely petition with the United States Tax Court challenging the Commissioner's determination. Pet. App. 6a.

3. The Tax Court upheld the Commissioner's determination that the portion of the settlement in Mr. Banks's discrimination lawsuit paid to Mr. Banks's attorney as a contingent fee constituted taxable income to Mr. Banks. Pet. App. 52a.

4. Mr. Banks appealed the Tax Court's decision. Expressly relying on its previous decision in *Estate of Clarks v. Commissioner*, 202 F.3d 854 (6th Cir. 2000), the court of appeals below reversed the Tax Court. In *Estate of Clarks*, the court of appeals held that the taxpayer in that case was not required to include in his or her gross income the attorney's contingent fee portion of a recovery: "The income should be charged to the one who earned it and received it [i.e., the attorney], not as under the government's theory of the case, to one who neither received it nor earned it [i.e., the taxpayer-client]." 202 F.3d at 858. Consistent with its prior precedent in *Estate of Clarks*, the court of appeals held that the portion of the settlement paid to Mr. Banks's attorney as a contingent fee was not income to Mr. Banks. Pet. App. 25a.

ARGUMENT

1. The Commissioner has consistently opposed, and this Court has routinely denied, a grant of certiorari on the precise federal income tax issue on which the Commissioner now seeks certiorari. *Sinyard v. Commissioner*, 268 F.3d 756 (9th Cir. 2001), *cert. denied*, No. 01-1380, 536 U.S. 904 (2002) (Commissioner's brief in opposition available at 2002 WL 32135079); *Hukkanen-Campbell v. Commissioner*, 247 F.3d 1312 (10th Cir. 2001), *cert. denied*, No. 01-1348, 535 U.S. 1056 (2002)[1]; *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, No. 00-1326, 532 U.S. 972 (2001)

[1] The Commissioner's brief in opposition is available at <http://www.usdoj.gov/osg/briefs/2001/0responses/2001-1348.resp.html>.

(Commissioner's brief in opposition available at 2000 WL 34000205); *Benci-Woodward v. Commissioner*, 219 F.3d 941 (9th Cir. 2000), *cert. denied*, No. 00-592, 531 U.S. 1112 (2001) (Commissioner's brief in opposition available at 2000 WL 34000856).

Far from "exacerbat[ing]" (Pet. 3) any perceived conflict among the circuits, the decision of the court of appeals below is in accord with other decisions in existence at the time when the Commissioner had previously been opposing certiorari on this issue with great vigor. The court of appeals below carefully explained that it was adopting the approach it had previously taken in *Estate of Clarks*, *supra*, and that the Fifth Circuit had taken in *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000). In those cases, the state attorney lien laws governing the taxpayers' relationships with their attorneys were considered in conjunction with other factors. The court of appeals below explained:

> [T]he reasoning in *Estate of Clarks* case seems to have been based on more than the nature of Michigan's lien law. To be sure, the similarity between Michigan's attorney's lien statute in *Estate of Clarks* and Alabama's attorney's lien statute in *Cotnam* [*v. Commissioner*, 263 F.2d 119 (5th Cir. 1959)] played a role in the outcome. *Estate of Clarks*, 202 F.3d at 856. However, we found other factors persuasive in distinguishing contingency fees from *Lucas* [*v. Earl*, 281 U.S. 111 (1930)] and [Helvering v.] *Horst*, [311 U.S. 112 (1940)] including the following: (1) the fact that the claim, at the time the contingency fee agreement was signed, was "an intangible, contingent expectancy," (2) taxpayer's claim was like a partnership or joint venture in which the taxpayer assigned away one-third in hope of recovering two-thirds; (3) no tax-avoidance purpose was at work with the contingency fee arrangement, as there ostensibly was in *Lucas* and *Horst*; and (4) double taxation would

otherwise result by including the contingency fee in taxpayer's income. *Id.* at 857-58.

Pet. App. 24a. *See also* Pet. App. 23a ("We find persuasive the reasoning of the Fifth Circuit, which recently faced similar factual circumstances") (citing *Srivastava*); and Pet. App. 25a (holding that "*Estate of Clarks* is controlling in the present case").

Estate of Clarks and *Srivastava* were already decided—and published in the Federal Reporter, Third Series—when the Commissioner, in opposing certiorari in *Sinyard*, *Coady*, *Hukkanen-Campbell*, and *Benci-Woodward*, represented to this Court, *in each case*, that "The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted." *Coady* opposition brief, 2000 WL 34000205, at *4; *Benci-Woodward* opposition brief, 2000 WL 34000856 at *5; *Hukkanen-Campbell* opposition brief, *supra; see also Sinyard* opposition brief, 2002 WL 32135079, at *5 (stating same).

The Commissioner's opposition brief in *Benci-Woodward* is instructive. In *Benci-Woodward*, the Ninth Circuit held that, chiefly because it determined that California's attorney lien law does not convey to an attorney any ownership interest in his or her client's lawsuit, the attorney contingent fee portion of a punitive damages recovery is taxable to the client. 219 F.3d at 943. In opposing certiorari in *Benci-Woodward*, the Commissioner represented to this Court that neither *Estate of Clarks* nor *Srivastava*—cases expressly relied on by the court of appeals in this case—were in direct conflict with *Benci-Woodward*. *Benci-Woodward* brief in opposition, 2000 WL 34000856, at **6-7 (discussing *Estate of Clarks* and *Srivastava* and concluding that "The decisions cited by petitioners thus do not directly conflict with the decision in this case"). The Commissioner, in his

Benci-Woodward opposition, carefully explained for this Court why the *Benci-Woodward* decision did not "directly conflict" (2000 WL 34000856, at *7) with the Fifth Circuit's decision in *Srivastava*:

> The Fifth Circuit did not determine precisely what rights the plaintiff had transferred to his attorney in *Srivastava*; the court did, however, note its view that, under Texas law, the "attorney retainer agreements accompanied by contingent fee provisions assign more than just the fruit" even though they may have divested the taxpayers of "something less than the entire tree."

2000 WL 34000856, at *7 n.4 (quoting *Srivastava*, 220 F.3d at 360).

Similarly, the court of appeals in this case, after "find[ing] persuasive the reasoning of the Fifth Circuit" in *Srivastava* (Pet. App. 23a), employed the same fruit-and-tree metaphor to explain that, whatever the precise intricacies of an attorney's bundle of rights under California law, as a practical matter, "By signing the contingency fee agreement, [Mr. Banks] transferred some of the trees from the orchard, rather than simply transferring some of the orchard's fruit." Pet. App. 25a (citing *Estate of Clarks*, 202 F.3d at 358).

In addition, the *Benci-Woodward* court, unlike the court of appeals below, and unlike the courts of appeals in *Estate of Clarks* and *Srivastava*, did not analyze whether the anticipatory assignment of income doctrine applies to an attorney contingent fee contract. Thus, by the Commissioner's own reasoning in his *Benci-Woodward* opposition, the decision of the court of appeals below no more conflicts with *Benci-Woodward* than does *Estate of Clarks* or *Srivastava*. At best, any conflict between the decision of the court of appeals below and *Benci-Woodward* is over the practical significance of California's

attorney lien law. But such a shallow, recent, and narrow conflict does not merit review by this Court.

2. a. Contrary to the Commissioner's conclusory assertion that the decision of the court of appeals below "fails to apply elementary tax principles" (Pet. 8), the court of appeals correctly determined that the attorney's contingent fee portion of a recovery is not income to the taxpayer-client.

The court of appeals carefully and correctly explained why an attorney contingent fee contract should be contrasted with the classic intra-family anticipatory assignment of income cases such as *Lucas v. Earl* and *Helvering v. Horst*, *supra*. In *Lucas* and in *Horst*, this Court rejected the taxpayers' attempts to escape the bite of the progressive marginal tax rate by splitting or donating earned income with family members. As Justice Holmes, writing for this Court in *Lucas*, explained, "no distinction can be made according to the arrangement by which fruits are attributed to a different tree on which they grew." 281 U.S. at 115.

The court of appeals below, however, explained that, based on the reasoning of its previous decision in *Estate of Clarks*, the anticipatory assignment of income doctrine does not apply to a contingent fee contract between an attorney and his or her client, which is an arm's length transaction not involving a tax avoidance motive. Pet. 22a. Further, the court of appeals explained that the anticipatory assignment of income doctrine also does not apply where—unlike *Lucas* and *Horst*—the income assigned is speculative and unaccrued at the time of transfer, and contingent upon the efforts and personal skill of the assignee. Pet. App. 22a. As the court of appeals explained in its previous decision in *Estate of Clarks*:

> In *Lucas* and *Horst*, the income assigned to the assignee was already earned, vested and relatively certain to be paid to the assignor. It was a gift of accrued income to a family member. The assignor's purpose was to split income with a family member and avoid the donor's higher rate under the progressive income tax. The income had a tangible known value to the assignor. The assignee performed no services in order to receive the income. There was no business purpose other than tax avoidance. There was no joint venture to reduce a speculative claim to money. Not so in this case. Here there was no res, no fund, no proceeds, no vested interest, only a hope to receive money from the lawyer's efforts and the client's right, a right yet to be determined by judge and jury.

202 F.3d at 857. Employing Justice Holmes's metaphor in *Lucas* of the fruit-and-tree, the *Estate of Clarks* court explained further:

> The present transaction under scrutiny is more like a division of property than an assignment of income. Here the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract. Here the lawyer's income is the result of his own personal skill and judgment, not the skill or largess of a family member who wants to split his income to avoid taxation.

Id. at 857-58.

b. In addition, "elementary tax principles" (Pet. 8) dictate that a litigant like Mr. Banks lacks the requisite control to be charged with income on the amount of lawsuit proceeds paid to his attorney as a contingent fee. This Court has established that unfettered control is the hallmark of income:

> It is not enough to trace income to the property which is its true source, a matter which may become more metaphysical than legal. Nor is the tax problem with which we are concerned necessarily answered by the fact that such property, if it can be properly identified, has been assigned. The crucial question remains whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes.

Commissioner v. Sunnen, 331 U.S. 591, 604 (1948). The contingent fee contract Mr. Banks entered into operated to shift practical control of the contingent fee portion of the settlement proceeds from Mr. Banks to his attorney. Mr. Banks did not have uncontrolled discretion over the portion of the settlement proceeds rightfully retained by his attorney; he had no right to divest his attorney of the portion of the settlement paid to his attorney as a contingent fee. Accordingly, that portion of the settlement proceeds cannot be income to Mr. Banks.

3. The Court should deny the Commissioner's petition for certiorari because pending Congressional legislation, if enacted, would effectively moot the issue upon which the Commissioner seeks certiorari in future cases presenting the same question.

The proposed "Civil Rights Tax Relief Act of 2003," H.R. 1155 and S. 557, 108th Congress (2003), would, if enacted, amend the Internal Revenue Code to exclude from gross income "amounts received by a claimant (whether by suit or agreement and whether as lump sums or periodic payments) on account of unlawful discrimination." Under the proposed legislation, although backpay and frontpay would be taxed as if earned over the period of years to which the recovery relates, attorneys' fees recovered from discrimination defendants would be excluded under the provision quoted above.

The House bill was introduced on March 6, 2003 by a bipartisan coalition of legislators, and is currently pending in the House Committee on Ways and Means. The parallel Senate bill was proposed the same day and referred to the Senate Finance Committee. Senator Charles Grassley, the Chairman of the Senate Finance Committee, has recently stated that he favors the passage of the proposed legislation or its equivalent:

> "It remains a high priority for me that we end this terrible policy where individuals are subject basically to double taxation when they receive a settlement payment," Sen. Grassley said in an e-mail. "We passed legislation in the Senate last year to address this, and I hope we can get the bill to the president's desk this year."

Tom Herman, *How You Can Lose by Winning a Suit*, WALL ST. JOURNAL, Feb. 12, 2004, at D2.

It should be noted that although the proposed legislation would, if enacted, effectively moot the issue upon which the Commissioner seeks certiorari, nothing in the Internal Revenue Code, *as currently in effect*, expressly provides that a discrimination claimant must include in his or her gross income the attorney's contingent fee portion of a recovery. In circular fashion, section 61(a) of the Internal Revenue Code defines gross income as "all income from whatever source derived." This Court developed the anticipatory income doctrine as a *judicial* doctrine in *Lucas* and *Horst* to determine what constitutes "income" for purposes of section 61(a). With great care and in great detail, the court of appeals below explained why the anticipatory of assignment of income doctrine does *not* apply to an attorney contingent fee contract. Pet. App. 18a-25a. Thus, the fact that there exists in Congress proposed legislation that would moot this issue should not raise the inference that the Internal Revenue Code, *as currently in effect*, mandates the result

the Commissioner now seeks. Rather, the proposed legislation would apply broadly to exclude from successful plaintiffs' gross incomes *all* non-backpay and non-frontpay portions of discrimination awards, including amounts paid by discrimination defendants to plaintiffs' attorneys.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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No. 03-892

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN W. BANKS, II

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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Respondent has provided no persuasive reason for this Court to leave unreviewed the Sixth Circuit's decision holding that litigation proceeds paid to a taxpayer s attorney pursuant to a contingent fee agreement are never includible in the taxpayer's gross income, *regardless* of how state law defines the attorney's interest in the proceeds. As explained below and in the petition for a writ of certiorari (Pet. 7-17), the court of appeals' decision is inconsistent with decisions of the Second, Third, Fourth, Seventh, Ninth, Tenth, and Federal Circuits, and it exacerbates a pre-existing circuit conflict over the tax treatment of

contingent fees paid to attorneys out of the proceeds of litigation brought by a taxpayer.

Respondent does not seriously dispute that the courts of appeals are divided over the question presented in the petition. See Br. in Opp. 5-6. Instead, he complains (*id.* at 2-5) that the government has opposed certiorari in prior cases raising the same or a similar question and has taken the position that the court of appeals decisions in those cases did not create a direct circuit conflict. He also contends that the decision below was correct (*id.* at 6-8), and that pending legislation in Congress might, if enacted, lessen the significance of the question presented in this case (*id.* at 8-10). None of those arguments provides a basis for denying certiorari in this case.

1. a. Prior to the Sixth Circuit's decision in this case, the courts of appeals had adopted two approaches to the question whether litigation proceeds paid to a taxpayer's attorney pursuant to a contingent fee agreement are includible in the litigant's gross income under 26 U.S.C. 61(a). The Fourth, Seventh, and Tenth Circuits had held that as a matter of federal law such proceeds are always includible in the litigant's gross income. See *Young* v. *Commissioner*, 240 F.3d 369, 378 (4th Cir. 2001); *Kenseth* v. *Commissioner*, 259 F.3d 881, 883 (7th Cir. 2001); *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d 1312 (10th Cir. 2001), cert. denied, 535 U.S. 1056 (2002). The Third, Fifth, Sixth, Ninth, Eleventh, and Federal Circuits had held that the tax treatment of contingent fee proceeds turns on whether state law treats the contingent fee arrangement as merely providing the attorney a lien on the proceeds of the litigation, similar to liens afforded other creditors, or whether it effects an "assignment" or transfer to the attorney of a part of the litigant's cause of action.

See, *e.g.*, *O'Brien* v. *Commissioner*, 319 F.2d 532 (3d Cir. 1963), aff'g 38 T.C. 707 (1962), cert. denied, 375 U.S. 931 (1963); *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959); *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2001); *Benci-Woodward* v. *Commissioner*, 219 F.3d 941 (9th Cir. 2000), cert. denied, 531 U.S. 1112 (2001); *Davis* v. *Commissioner*, 210 F.3d 1346 (11th Cir. 2000); *Baylin* v. *United States*, 43 F.3d 1451 (Fed. Cir. 1995).

The Sixth Circuit in this case rejected both of those approaches. Like the Fourth, Seventh, and Tenth Circuits, the Sixth Circuit held that the proper tax treatment of contingency fee proceeds "does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state." Pet. App. 23a-24a (citation omitted). But unlike each of those circuits, the court of appeals below held that as a matter of federal law such proceeds are *never* includible in the litigant's gross income. *Id.* at 25a. The decision below therefore directly conflicts with the decisions of the Fourth, Seventh, and Tenth Circuits.

It also conflicts with the decisions of those courts of appeals that have looked to state law to determine the tax treatment of contingency fee proceeds. Most directly, the decision below conflicts with the Ninth Circuit's decision in *Benci-Woodward* v. *Commissioner*, *supra*. In *Benci-Woodward*, the Ninth Circuit held that a contingent fee agreement made under California law gives the attorney only a lien on the client's prospective recovery and does not transfer to the attorney any proprietary interest in the client's cause of action. 219 F.3d at 943. Accordingly, the court held, it necessarily follows that the entire amount of the damages awarded to the taxpayer, including the por-

tion that is paid directly to the taxpayer's attorneys under the contingent fee agreement, must be included in the taxpayer's gross income. *Ibid.*

As in *Benci-Woodward*, the contingent fee agreement in this case was made under California law. Far from taking issue with the Ninth Circuit's interpretation of California law, the Sixth Circuit quoted it with approval. Pet. App. 23a. It nevertheless held that contingent fee proceeds could not be included in the litigant's gross income, even though under applicable state law the attorney was treated like other creditors and had no ownership interest in the litigant's cause of action. As the court explained, it simply decided that it would "not * * * draw distinctions based on the lien theory of the particular state in which an action arises." *Ibid.*

Prior to the decision in this case, *every* court of appeals to consider the issue had held that litigation proceeds paid to a taxpayer's attorney as contingent fees are includible in the taxpayer's gross income where state law defines the interest conferred on the attorney by the contingent fee agreement as a security interest rather than an ownership interest. After the Sixth Circuit's decision, two litigants with identical claims and identical contingent fee agreements made under California law could be subject to starkly different tax treatment on their litigation proceeds based solely on the jurisdiction in which the tax dispute was brought. It is precisely such "inequalities in the administration of the revenue laws" that this Court has sought to avoid. *Commissioner* v. *Sunnen*, 333 U.S. 591, 599 (1948).

b. Nothing in the government's briefs opposing certiorari in *Benci-Woodward* and the other cases cited by respondent (Br. in Opp. 2-6) undermines the conclusion that this Court's review is needed to resolve

the widening circuit conflict on the question presented in the petition. In its brief opposing certiorari in *Benci-Woodward*, the Government noted that "[i]n none of the cases on which petitioner relies did a court hold that a plaintiff who merely gives a contractual lien to an attorney—and who does not assign to the attorney ownership rights in the cause of action—need not include the entire award in his gross income." Br. in Opp. at 6-7, *Benci-Woodward*, *supra* (No. 00-592); see Br. in Opp. at 5, *Hukkanen-Campbell*, *supra* (No. 01-1348) (arguing that "[f]or the same reasons stated in our brief in opposition to the petition for a writ of certiorari in *Benci-Woodward*, the petition for a writ of certiorari should be denied in this case"); Br. in Opp. at 4, *Coady* v. *Commissioner*, 532 U.S. 972 (2001) (No. 00-1326) (same); Br. in Opp. at 8-9, *Sinyard* v. *Rossotti*, 536 U.S. 904 (2002) (No. 01-1380) (same). That, however, is precisely the holding of the Sixth Circuit below, and that holding adds a new and divergent decisional approach to the pre-existing conflict over whether such proceeds must always be included in the taxpayer's gross income, or must be included only when state law does not provide the lawyer with an ownership interest in the taxpayer's cause of action.

c. Ultimately, respondent appears to concede the existence of a "conflict between the decision of the court of appeals below and *Benci-Woodward* * * * over the practical significance of California's attorney lien law." Br. in Opp. 5-6. But he contends that "such a shallow, recent, and narrow conflict does not merit review by this Court." *Id.* at 6. Respondent is mistaken. This Court's review is necessary to resolve the conflict over the proper tax treatment of litigation proceeds paid directly to the taxpayer's attorneys

under a contingent fee agreement, and this case provides an ideal vehicle for addressing that issue.

Contingent fee agreements are an important and common feature in many types of litigation. The question presented in this case therefore recurs frequently and has substantial importance to the proper administration of the tax laws. As the discussion above and in the petition for a writ of certiorari demonstrate, the conflict over this question is widespread and irreconcilable.

Indeed, after the petition for a writ of certiorari was filed in this case, the Second Circuit decided a case presenting this same issue, *Raymond* v. *United States*, 355 F.3d 107 (2004). The Second Circuit held that principles of federal tax law require that the portion of a damages recovery paid to a Vermont attorney under a contingent fee agreement be included in the client's gross income. Discussing the taxpayer's contingent attorney's fees, the court of appeals stated that:

> Raymond "control[led] the source of the income [and] . . . divert[ed] the payment from himself to others as the means of procuring the satisfaction of his wants." [*Helvering* v. *Horst*, 311 U.S. 112, 116-117 (1940).] He diverted a portion of his judgment to his attorney in the service of receiving the remainder of that judgment—certainly a result "procurable only by the expenditure of money or money's worth." [*Id.* at 117]. Accordingly, the judgment flowing to Raymond is income to him, and the expense of producing that income—his attorney's fee—is a deductible expense. *See* [26 U.S.C.] § 212(1). That the Alternative Minimum Tax precludes Raymond from taking advantage of that deduction is unfortunate, * * * but it is not a reason to create an artificial contingent-fee exception to the rule that one is taxable on income from a source over which one retains control.

Id. at 115.

Thus, the Second Circuit has now joined the Fourth, Seventh, and Tenth Circuits in holding that federal tax law requires successful litigants to include in gross income the portion of a damages recovery paid to the litigant's attorney without regard to the rights of the attorney under state law to protect his claim for fees. As the Second Circuit's decision further demonstrates, the conflict over this issue is well developed and important. The Second Circuit itself noted that "[w]hether contingent fees are includable in the gross income of a client recovering on a judgment is the subject of much debate among the circuit courts," *Raymond*, 355 F.3d at 109, and it specifically referred to the Sixth Circuit's decision in this case as having widened the conflict by "diverging from [the Ninth Circuit's decision in] *Benci-Woodward* on *federal* grounds," *id.* at 110. This Court's review is necessary to resolve the conflict and to eliminate the disparity that now exists among similarly situated taxpayers.

2. Respondent's attempts (Br. in Opp. 6-8) to characterize the Sixth Circuit's decision in this case as consistent with established principles of tax law are unavailing. As explained in the petition (Pet. 8-11), it is a fundamental rule of taxation that income is to be taxed to the person who earns it, even when it is paid at that person's direction to someone else. A contractual arrangement mandating that income to be received in the future is to be paid directly to the taxpayer's assignee does not shift the incidence of the tax away from the party who assigned the right to receive the

income. See *Lucas* v. *Earl*, 281 U.S. 111, 114-115 (1930); *Helvering* v. *Horst*, 311 U.S. 112, 114 (1940).

Contrary to respondent's assertions, the "anticipatory assignment" rule of *Lucas* and *Horst* applies with full force where the amount of the future income is not known at the time of the assignment and the assignee is obligated to provide services in exchange for the assignment. The contract at issue in *Lucas* involved an assignment of an uncertain amount of future income, see 281 U.S. at 113-114, and the fact that respondent's attorneys were obligated to perform services in exchange for the promised percentage of the litigation proceeds only demonstrates the error of respondent's argument (Br. in Opp. 7-8) that the portion of the settlement paid as attorney's fees was not income to him because he lacked control over it. Respondent exercised control over his right to the litigation proceeds when he promised a portion of those proceeds to his attorneys in exchange for legal services. As this Court explained in *Horst*, "where the enjoyment [of income] is consummated by some event other than the taxpayer's personal receipt of money or property," such as "when he has made such use or disposition of his power to receive or control the income as to procure in its place other satisfactions which are of economic worth," the income is includible in the taxpayer's gross income. 311 U.S. at 116; see *id.* at 118.

3. Respondent argues that the question presented in the petition is of limited significance because legislation has been proposed in Congress that would amend the Internal Revenue Code to exclude from gross income "amounts received by a claimant (whether by suit or agreement and whether as lump sums or periodic payments) on account of unlawful discrimination." Br. in Opp. 8-10 (quoting proposed "Civil Rights Tax Relief

Act of 2003," H.R. 1155 and S. 557, 108th Cong., 1st Sess. (2003)). Such pending legislation, however, does not remove the need for this Court's review. First, the legislation has merely been proposed, and it is far from clear that it will ever be enacted into law, much less enacted soon enough to reduce the need for this Court's review. Both the Senate and the House bill were referred to committee on March 6, 2003, and it appears that no action has been taken on either bill since that time. See *Bill Summary & Status for the 108th Congress* <http://thomas.loc.gov/cgi-bin/bdquery/z?d108:h.r.01155:>; *Bill Summary & Status for the 108th Congress* <http://thomas.loc.gov/cgi-bin/bdquery/z?d108:s.00557:>.

Second, even if the proposed legislation were enacted, it would not eliminate the issue presented here. The proposed legislation would provide for the exclusion from gross income of amounts received on account of certain claims of unlawful discrimination. Recoveries for punitive damages, however, would still be included in gross income, as would recoveries for backpay and frontpay, subject to the benefits of income averaging.

The question presented in the petition potentially arises whenever litigants enter into contingent fee contracts, and such contracts are a routine feature of many types of litigation other than claims of unlawful discrimination. Accordingly, the issue will continue to arise, and will do so frequently, regardless of whether Congress enacts the proposed legislation identified by respondent. Indeed, in this case, respondent originally sued not only for alleged violations of federal anti-discrimination statutes, but also for state tort law claims for, *inter alia*, tortious interference with business relations. See Pet. App. 2a-3a. Although respondent

abandoned his state tort law claims prior to the settlement, *id.* at 3a, the court of appeals held that the settlement was attributable to his claim for backpay, rather than to any claim for personal injury. *Id.* at 15a-16a. Thus, it appears that the proposed legislation would not even obviate the need to resolve the question presented in this case, much less the myriad other cases in which the question arises.*

* * * * *

For the foregoing reasons, and those stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

THEODORE B. OLSON
Solicitor General

MARCH 2004

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* The proposed legislation, if enacted, would not apply to this case in any event, since by its terms it would only "apply to damages received in taxable years beginning after December 31, 2002." H.R. 1155 and S. 557, *supra*, § 140(c). This case involves respondent's 1990 tax year.

Supreme Court, U.S.
FILED
JUN 14 2004
OFFICE OF THE CLERK

5 5

Nos. 03-892 and 03-907

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN W. BANKS, II

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SIGITAS J. BANAITIS

ON WRITS OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH AND NINTH CIRCUITS

JOINT APPENDIX

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for Respondent Banaitis

PETITIONS FOR WRIT OF CERTIORARI FILED:
DEC. 19, 2003 & DEC. 24, 2003
CERTIORARI GRANTED: MAR. 29, 2004

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UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 01-2171

JOHN W. BANKS, II, PETITIONER - APPELLANT

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT - APPELLEE

DOCKET ENTRIES

DATE	PROCEEDINGS
8/30/01	Tax Court Case Docketed. Notice filed by Appellant John W. Banks. (ert) [01-2171]
	* * * * *
3/12/03	CAUSE ARGUED on 3/12/03 by James R. Carty for Appellant John W. Banks in 01-2171/2177, Kenneth W. Rosenberg for Appellee CIR in 01-2171/2177, before Judges Moore, Clay, Lawson. [01-2171, 01-2177] (me) [01-2171 01-2177]
9/30/03	OPINION filed: The tax court's decision that Petitioner's California federal court suit settlement proceeds were not excludable from gross income under 26 U.S.C. 104 is AFFIRMED. The tax court's deter-

DATE	PROCEEDINGS
	mination that the contingency fees Petitioner paid his attorney constituted taxable income is REVERSED and the tax court's ruling that Petitioner could not deduct his alimony payments for the taxable 1990 year based on "duty of consistency" doctrine is REVERSED. The case is REMANDED to the tax court for further consideration. Decision for publication pursuant to local rule 206 [01-2171, 01-2177]. Karen N. Moore, Circuit Judge (concurring in part, dissenting in part), Eric L. Clay, Authoring Judge, David M. Lawson, District Judge. (dtk) [01-2171 01-2177]
9/30/03	JUDGMENT: AFFIRMED in part REVERSED in part and REMANDED (dtk) [01-2171 01-2177]
11/24/03	MANDATE ISSUED with no cost taxed [01-2171, 01-2177] (rgf) [01-2171 01-2177]
	* * * * *

UNITED STATES TAX COURT

No. 18096-97

JOHN W. BANKS, II, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

DOCKET ENTRIES

DATE	DOCKET NUMBER	PROCEEDINGS
		* * * * *
09/02/97	0001	PF Petition Filed: Fee Paid; R 09/04/97
10/27/97	0004	ACS ANSWER (C/S 10/24/97).
		* * * * *
03/20/00	0028	TRL TRIAL before Judge Laro at Chicago, IL SUB 03/27/00 Also called 3/24 & 3/27. Not called 3/28. 3/20 Pretrial conference held. Record held open for Resp. mot. for sanctions due 4/3/00 & Petr. John Banks, reply due 4/10/00.
		* * * * *

DATE	DOCKET NUMBER	PROCEEDINGS
03/20/00	0030	ATP AMENDMENT TO PETITION (CHI), R 04/07/00
		* * * * *
03/24/00	0031	STP STIPULATION OF FACTS w/Ex. (CHI)
		* * * * *
03/24/00	0033	ATA AMENDMENT TO ANSWER (CHI); P 04/07/00C
		* * * * *
02/28/01	0060	MOP 5 MEMORANDUM OPINION, Judge Laro T.C. Memo. 2001-48. (Decisions will be entered under Rule 155.) B 02/28/01C
		* * * * *
05/21/01	0066	DEC DECISION ENTERED, Judge Laro; B 05/21/01C
		APPELLATE PROCEEDINGS
08/21/01	0067	NOAP Notice of Appeal by petr. to U.S.C.A., 6th Cir. Fee Paid; B 08/22/01C
		* * * * *

UNITED STATES TAX COURT

No. 18096-97

JOHN W. BANKS, II, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[Filed: Sept. 2, 1997]

PETITION

The Petitioner hereby petitions for a redetermination of the deficiencies set forth by the Commissioner of Internal Revenue in the Commissioner's notice of deficiency dated May 30, 1997, and as the basis for the Petitioner's case alleges as follows:

1. Petitioner is an individual with mailing address now at 2138 Glen Road, Benton Harbor Michigan 49022. Petitioner's taxpayer identification number is 429-74-4519. The returns for the periods here involved were filed with the Office of Internal Revenue Service at Ogden, Utah.

2. The notice of deficiency (a copy of which is attached and marked Exhibit "A") was mailed to the Petitioner on May 30, 1997, and was issued by the Office of the Internal Revenue Service at Sacramento, California.

3. The deficiencies as determined by the Commissioner are in income taxes for the calendar years 1988,

1990 and 1991, in the amounts of $11,707, $101,168 and $8,722, of which $11,707, $101,168 and $8,722, respectively, are in dispute.

4. The determination of the tax set forth in the said notice of deficiency is based upon the following errors:

a) The Commissioner erroneously disallowed the net operating loss carryover for 1988, 1989, 1990 and 1991, in the amounts of $101,365, $67,104, $64,698 and $64,445.

b) The Commissioner erroneously included income with respect to the Title VII settlement in the amount of $464,000.

c) The Commissioner erroneously determined additional self-employment taxes in 1988 in the amount of $4,569. The Commissioner erroneously determined alternative minimum taxes for 1988 and 1990, in the amounts of $11,782 and $10,625.

5. The facts upon which the Petitioner relies, as the basis of Petitioner's case, are as follows:

a) Petitioner is entitled to the net operating loss carryovers in 1988, 1989, 1990 and 1991, in the amounts of $101,365, $67,106, $64,698 and $64,445.

b) Petitioner is not required to realize or recognize income from the Title VII settlement in 1990 in the amount of $464,000.

c) The Petitioner had no self-employment income in 1988, and therefore the self-employment taxes of $4,569 are not applicable.

d) The Petitioner is not liable for the alternative minimum taxes in 1988 and 1990, in the amounts of $11,782 and $10,625.

e) The Petitioner incurred and realized unspecified ordinary and capital losses in the years 1988, 1989 and 1990, in an amount exceeding $4,000,000. These losses were incurred in the years during this Tax Court case. The Petitioner filed bankruptcy through counsel in 1986, and was discharged in bankruptcy in 1990. The Petitioner had a cost basis in excess of $4,000,000 for the assets that were a part of the bankruptcy and the Petitioner only realized $3,500 at the time of discharge from the Bankruptcy Court in 1990. The Petitioner was both a dealer in property and had a partnership interest in the Frenchtown Hills and Auburn Bluff Projects. Most of these losses were never originally claimed by Petitioner's CPA, Eric Waddell. These losses are either allowable in 1990, the year of the bankruptcy discharge or in the alternative, in each year as they are sold by the Trustee for the Bankruptcy Court, John Roberts. The Forms 1041 that were filed by the Trustee were filed in the years 1986 through 1990. The final return from the bankruptcy was filed in 1990. The cumulative losses for the bankruptcy that were reported on the final Form 1041 for 1990 were $77,765. The $77,765 losses are ordinary income losses on Mr. Bank's Form 1040 for 1990 that were not reported and claimed by Eric Waddell. These represent additional ordinary losses for the 1990 year.

These losses will generate additional net operating losses of $4,000,000 for the years 1988, 1989, 1990 or 1991 . The Petitioner was previously levied by the IRS in 1990 or 1991 for some of these years. If the additional losses are allowed, these will generate a tax refund plus interest for the Petitioner for funds taken pursuant to the IRS levy in 1991 or 1992. Petitioner believes based upon best available information, that the

amount available for a refund is approximately $40,000 plus interest from the time the funds were levied by the IRS in 1990 or 1991, or an estimate of $65,000 - $80,000, with interest.

WHEREFORE Petitioner prays that:

1) There are no deficiencies due and owing from the Petitioner for the taxable years 1988, 1989 and 1990;

2) That the Court approve tax refunds for funds previously taken by the IRS pursuant to a levy in 1991 or 1992.

3) For such other and further relief as the Court shall deem proper.

Respectfully submitted,

ADMITTED U.S. TAX COURT

Dated: August 27, 1997

/s/ MICHAEL P. CASTERTON
MICHAEL P. CASTERTON, CM0383
CINNAMON, CASTERTON & HAGEDORN
1515 River Park Drive,
2nd Floor
Sacramento, CA 95815
916 929-6800

UNITED STATES TAX COURT

Nos. 18096-97, 18097-97

JOHN W. BANKS, II, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

STIPULATION OF FACTS

In accordance with Tax Court Rule 91(e), the below-signed parties agree to this Stipulation of Facts pursuant to the general terms of this preamble unless specifically expressed otherwise. The following statements may be accepted as facts and all exhibits referred to herein and attached hereto may be accepted as authentic and are incorporated in this stipulation and made a part hereof; provided that either party may introduce other and further evidence not inconsistent with the facts herein stipulated. The truth of assertions within stipulated exhibits may be rebutted or corroborated with additional evidence. All evidentiary objections except materiality and relevancy are waived unless specifically expressed within this stipulation. All copies shall be considered electronic reproductions of the originals and shall be treated as if originals.

VENUE AND JURISDICTION

1. At the time the petition in this case was filed, petitioners John W. Banks II ("John W. Banks") and

Nora J. Banks ("Nora Banks") each resided at 2138 Glen Road, Benton Harbor, Michigan 49022-6615.

2. A copy of the notice of deficiency dated May 30, 1997, upon which the case at Docket No. 18096-97 is based, is attached hereto as **Exhibit 1-J.**

3. A copy of the notice of deficiency dated May 30, 1997, upon which the case at Docket No. 18097-97 is based, is attached hereto as **Exhibit 2-J.**

INCOME TAX-RETURNS

4. A copy of petitioner John W. Banks's 1988 Form 1040 ("U.S. Individual Income Tax Return") is attached hereto as **Exhibit 3-J.**

5. A copy of petitioner John W. Banks's 1989 Form 1040 ("U.S. Individual Income Tax Return") is attached hereto as **Exhibit 4-J.**

6. A copy of petitioner John W. Banks's 1990 Form 1040 ("U.S. Individual Income Tax Return") is attached hereto as **Exhibit 5-J.**

7. A copy of petitioner John W. Banks's 1991 Form 1040 ("U.S. Individual Income Tax Return") is attached hereto as **Exhibit 6-J.**

8. John W. Banks and Nora Banks were married in late 1992.

9. John W. Banks and Nora Banks filed a 1992 Form 1040 ("U.S. Individual Income Tax Return") electing married filing jointly.

10. A copy of petitioners' 1992 Form 1040 ("U.S. Individual Income Tax Return") is attached hereto as **Exhibit 7-J.**

THE STATE OF CALIFORNIA DEPARTMENT OF EDUCATION LAWSUITS FILED BY JOHN W. BANKS

11. During the years 1972 through July 14, 1986, petitioner John W. Banks was employed as an educational consultant by the Department of Education, State of California.

12. In 1983, John W. Banks filed a charge with the Equal Employment Opportunity Commission ("EEOC") against the California State Department of Education.

13. By letter dated April 20, 1984, the Civil Right Division of the EEOC notified John W. Banks that he had the right to file a civil action under Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. 2000e, against the California State Department of Education. A copy of said letter is attached hereto as **Exhibit 8-J.** This letter is a jurisdictional prerequisite to filing suit in Federal District Court under the aforementioned statute, pursuant to 42 U.S.C. 2000e-5(f)(1).

14. On June 28, 1984, petitioner John W. Banks filed a complaint against William Honig, et al. (including the State Department of Education, State of California), in Docket No. 84CIVS-0836, under 42 U.S.C. 2000e, Title *VII* , and 42 U.S.C. 1981.

15. On January 15, 1985, John W. Banks filed a Second Amended Complaint in Docket No. 84-CIVS-0836, under 42 U.S.C. 2000e, Title VII, and under 42 U.S.C. § 1983. A copy of that complaint is attached hereto as **Exhibit 9-J.**

16. Petitioner's employment with the California State Department of Education was terminated on July 14, 1986.

17. On November 25, 1987, petitioner John W. Banks filed suit against William Honig, et al. (including the State Department of Education, State of California), as Docket No. 87-CIVS-1658, under 42 U.S.C. 2000e and 42 U.S.C. 1983.

18. Docket No. 87-CIVS-1658 was consolidated with Docket No. 84-0836 on January 19, 1989, with Docket No. 84-0836 becoming the lead case.

19. A copy of the court's pretrial order dated September 22, 1989, is attached hereto as **Exhibit 10-J.**

20. The trial in the consolidated cases commenced on May 1, 1990, continuing for nine days.

21. The parties settled the cases prior to judgment by the court and entered into a settlement agreement and release. A copy of that Settlement Agreement and Release, dated May 30, 1990, is attached hereto as **Exhibit 11-J.**

22. The cases were dismissed on March 30, 1990 by Judge Lawrence K. Karlton.

23. Copies of the docket sheets for Docket Nos. 84-CIVS-0836 and 87-CIVS-1658 are attached hereto as **Group Exhibits 12-J.**

JOHN W. BANKS'S BANKRUPTCY CASE

24 On July 29, 1986, petitioner John W. Banks filed a voluntary petition in the United States Bankruptcy Court for the Eastern District of California. That petition was assigned Docket No. 286-03775-D-7. A copy of that petition, together with attached schedules, is attached hereto as **Exhibit 13-J.**

25. On August 8, 1986, the U.S. Bankruptcy Court appointed John Roberts, Inc., as Interim Trustee of the

debtor estate of John W. Banks II, Docket No. 286-03775. A copy of that order is attached hereto as **Exhibit 14-J.**

26. On August 25, 1986, John R. Roberts filed an application requesting an order from the bankruptcy court approving the employment of a firm to market and sell a real estate subdivision known as Frenchtown Hills which was an asset of the bankruptcy estate. A copy of said application is attached hereto as **Exhibit 15-J.**

27. On April 19, 1993, the Trustee filed the Trustee's Final Report and Proposed Distribution in Case No. 286-03775-B-7. A copy of that report is attached hereto as **Exhibit 16-J.**

28. On July 19, 1993, the Bankruptcy Court entered its Order Approving Trustee's Final Report and Order for Payment of Dividends. A copy of said order is attached hereto as **Exhibit 17-J.**

29. On October 29, 1993, the Trustee filed the Trustee's Report of Final Account and Request for Closing and Discharge of Trustee. A copy of that report with attached certification of review by the United States Trustee dated November 24, 1993, is attached hereto as **Exhibit 18-J.**

30. On December 29, 1993, the Bankruptcy Court entered its Final Decree ordering the bankruptcy estate closed. A copy of that order is attached hereto as **Exhibit 19-J.**

PETITIONERS' DIVORCE

31. John W. Banks and Nora Banks, now known as Nora Jefferson, were divorced in 1999, with the Judgment of Divorce becoming final on October 8, 1999.

32. A copy of the Judgment of Divorce in the case John Wesley Banks, II v. Nora Jefferson Banks, Case No. 98-2463-DO-M, Berrien County Trial Court - Family Division, State of Michigan, is attached hereto as **Exhibit 20-J**.

ADDITIONAL RETURNS

33. A copy of petitioner John W. Banks's 1983 Form 1040 ("U.S. Individual Income Tax Return") is attached hereto as **Exhibit 21-R**.

34. A copy of petitioner John W. Banks's 1984 Form 1040 ("U.S. Individual Income Tax Return") is attached hereto as **Exhibit 22-R**.

35. A copy of petitioner John W. Banks's 1985 Form 1040 ("U.S. Individual Income Tax Return") is attached hereto as **Exhibit 23-R**.

36. A copy of petitioner John W. Banks's 1986 Form 1040 ("U.S. Individual Income Tax Return") is attached hereto as **Exhibit 24-R**.

37. A copy of petitioner John W. Banks's 1987 Form 1040 ("U.S. Individual Income Tax Return") is attached hereto as **Exhibit 25-R**.

38. A copy of petitioner John W. Banks's 1987 Form 1040X ("Amended U.S. Individual Income Tax Return") is attached hereto as **Exhibit 26-R**.

39. A copy of petitioners John W. Banks's and Nora J. Banks's 1993 Form 1040 ("U.S. Individual Income Tax Return") is attached hereto as **Exhibit 27-R**.

John W. Banks II and Verna Jo Banks Divorce-Proceedings and Related Matters

40. A copy of a pleading entitled "Deposit in Lieu of Undertaking for Stay Pending Appeal," In re the

Marriage of Verna J. Banks and John W. Banks II, Docket No. 748218, Superior Court of California, County of Sacramento, is attached hereto as **Exhibit 28-R**.

41. A copy of a pleading entitled "Ruling on Submitted Matter," dated October 30, 1998, In re the Marriage of Verna J. Banks and John W. Banks II, Docket No. 748218, Superior Court of California, County of Sacramento, is attached hereto as **Exhibit 29-R**.

42. A copy of a pleading entitled "Declaration of Jay-Allen Eisen in Support of Motion for Attorney Fees and for Enforcement Order," In re the Marriage of Verna J. Banks and John W. Banks II, Docket No. 748218, Superior Court of California, County of Sacramento, is attached hereto as **Exhibit 30-R**.

43. A copy of a pleading entitled "Points and Authorities in Support of Motion for Attorney Fees," In re the Marriage of Verna J. Banks and John W. Banks II, Docket No. 748218, Superior Court of California, County of Sacramento, is attached hereto as **Exhibit 31-R**.

44. A copy of a pleading entitled "Order Awarding Attorney Fees and Costs on Appeal," In re the Marriage of Verna J. Banks and John W. Banks II, Docket No. 748218, Superior Court of California, County of Sacramento, is attached hereto as **Exhibit 32-R**.

45. A copy of a facsimile transmission from James B. Macy, Attorney, to John Banks, dated March 9, 1993, together with attached pleadings entitled "Notice of Entry of Judgment," "Order Fixing Amount Due Petitioner for her Community Property Interest in

Respondent's Military Retired Pay from Date of Separation to Date Respondent Filed Bankruptcy," "Notice of Entry of Judgment," and "Order on Stipulation," all dated March 5, 1993, is attached hereto as **Exhibit 33-R**.

STUART L. BROWN
Chief Counsel
Internal Revenue Service

[Signature illegible]
WILLIAM J. WISE
Counsel for Petitioner
John W. Banks II
Wise and Stracks
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Telephone: (312) 236-6556

By: /s/ LINDA C. GROBE
LINDA C. GROBE
Attorney
Tax Court Bar
No. GL0351

/s/ NORA J. BANKS
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Petitioner
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/s/ WILLIAM E. BOGNER
WILLIAM E. BOGNER
Assistant District Counsel
Tax Court Bar No. BW0357
200 West Adams Street
Suite 2300
Chicago, Illinois 60606
Telephone: (312) 886-9225

Date: [3/22/00]

Date: [MAR 22, 2000]

Internal Revenue Service **Department of the Treasury**

CERTIFIED MAIL: 100941346 Date: 30 May, 1997

JOHN W. BANKS, II
2138 GLEN ROAD
BENTON, HARBOR, MI
49022-6615

In Reply Refer to:
W:AP:SAC:DS:JF
Person to Contact:
DAVE SMITH
Contact Telephone Number:
(916) 974-5815
TIN: 429-74-4519

Tax Year Ended:	Deficiency
December 31, 1988	$ 11,707.00
December 31, 1990	$ 101,168.00
December 31, 1991	$ 8,772.00

Dear Taxpayer:

We determined that you owe an additional amount, as shown above. This letter is your NOTICE OF DEFICIENCY as required by law. The enclosed statement shows how we figure the deficiency.

If you want to contest this deficiency in court before making any payment, you have 90 days from the above mailing date of this letter (150 days if addressed to you outside the United States) to file a petition with the United States Tax Court for a redetermination of the deficiency. To get a petition form and the rules for filing a petition, write to: United States Tax Court, 400 Second Street NW, Washington, D.C. 20217.

Send the completed petition form, a copy of this letter, and a copy of all statements and schedules you received with this letter, to the Tax Court at the same address.

The time you have to file a petition with the Court (90 or 150 days) is fixed by law. The Court cannot consider your case if you file the petition later.

If this letter is addressed to both husband and wife, and both want to petition the Tax Court, both must sign and file the petition or each must file a separate, signed petition. If only one of you petitions the Tax Court, the full amount of the deficiency will be assessed against the non-petitioning spouse.

Small Tax Cases

The Tax Court has a simplified procedure for small tax cases, when the amount in dispute is $10,000 or less for any one tax year. You can get information about this procedure, as well as a petition form, by writing to the Clerk of the United States Tax Court at the court address shown in the second paragraph above. You should write promptly if you intend to file a petition with the court.

If you decide not to file a petition with the Tax Court, please sign and return the enclosed waiver form. This will permit us to assess the deficiency quickly and will limit the accumulation of interest. The enclosed envelope is for your convenience.

If you are a C corporation, under Internal Revenue Code Section 6621(c), large corporate underpayments may be subject to a higher rate of interest than the normal rate of interest for underpayments.

If you decide not to sign and return the waiver, and you don't file a petition with the Tax Court within the time limit, the law requires us to assess and bill you for the deficiency after 90 days from the above mailing date (150 days if this letter is addressed to you outside the United States).

If you have any questions about this letter, you may call or write to the person whose name is shown above. If the telephone number is outside your local calling area, you will be charged for a long distance call. If you write, please attach a copy of this letter to help us identify your account. Also, include your daytime telephone number so we can call you if necessary.

Sincerely yours,
Margaret Milner Richardson
Commissioner
by

[SIGNATURE ILLEGIBLE]

Associate Chief
Appeals Office

Enclosures:
Copy of this letter
Statement
Waiver
Envelope

Northern California Appeals
Sacramento Office
3310 El Camino Avenue
Suite 170
Sacramento, CA 95821-6308

Ltr 894 (RO)(Rev.4-93)

Internal Revenue Service | **Department of the Treasury**

CERTIFIED MAIL: 100941345 | Date: 30 May, 1997

In Reply Refer to:
W:AP:SAC:DS:JF
Person to Contact:
DAVE SMITH
Contact Telephone Number:
(916) 974-5815
TIN: 429-74-4519

JOHN W. BANKS, II AND
NORA J. JEFFERSON-BANKS
2138 GLEN ROAD
BENTON, HARBOR, MI
49022-6615

Tax Year Ended:	Deficiency
December 31, 1992	$ 24,654.00

Dear Taxpayer:

We determined that you owe an additional amount, as shown above. This letter is your NOTICE OF DEFICIENCY as required by law. The enclosed statement shows how we figure the deficiency.

If you want to contest this deficiency in court before making any payment, you have 90 days from the above mailing date of this letter (150 days if addressed to you outside the United States) to file a petition with the United States Tax Court for a redetermination of the deficiency. To get a petition form and the rules for filing a petition, write to: United States Tax Court, 400 Second Street NW, Washington, D.C. 20217.

Send the completed petition form, a copy of this letter, and a copy of all statements and schedules you

received with this letter to the Tax Court at the same address.

The time you have to file a petition with the Court (90 or 150 days) is fixed by law. The Court cannot consider your case if you file the petition later.

If this letter is addressed to both husband and wife, and both want to petition the Tax Court, both must sign and file the petition or each must file a separate, signed petition. If only one of you petitions the Tax Court, the full amount of the deficiency will be assessed against the non-petitioning spouse.

Small Tax Cases

The Tax Court has a simplified procedure for small tax cases, when the amount in dispute is $10,000 or less any one tax year. You can get information about this procedure, as well as a petition form, by writing to the Clerk of the United States Tax Court at the court address shown in the second paragraph above. You should write promptly if you intend to file a petition with the court.

If you decide not to file a petition with the Tax Court, please sign and return the enclosed waiver form. This will permit us to assess the deficiency quickly and will limit the accumulation of interest. The enclosed envelope is for your convenience.

If you are a C corporation, under Internal Revenue Code Section 6621(c), large corporate underpayments may be subject to a higher rate of interest than the normal rate of interest for underpayments.

If you decide not to sign and return the waiver, and you don't file a petition with the Tax Court within the time limit, the law requires us to assess and bill you for

the deficiency after 90 days from the above mailing date (150 days if this letter is addressed to you outside the United States).

If you have any questions about this letter, you may call or write to the person whose name is shown above. If the telephone number is outside your local calling area, you will be charged for a long distance call. If you write, please attach a copy of this letter to help us identify your account. Also, include your daytime telephone number so we can call you if necessary.

Sincerely yours,
Margaret Milner Richardson
Commissioner
by

/s/ A.M. SPOONS
Associate Chief
Appeals Office

Enclosures:
Copy of this letter
Statement
Waiver
Envelope

Northern California Appeals
Sacramento Office
3310 El Camino Avenue
Suite 170
Sacramento, CA 95821-6308 Ltr 894(RO)(Rev.4-93)

SETTLEMENT AGREEMENT AND RELEASE

This Settlement Agreement and Release is entered into by and between plaintiff John Banks (plaintiff) and defendants California State Department of Education (Department), et. al. in the federal actions, No. CIV S-84-836, and No. CIV 87-1658, as of May 30, 1990.

RECITALS

A. Plaintiff was employed as a consultant by the California State Department of Education until his discharge effective July 14, 1986.

B. Plaintiff brought actions against named defendants and the California State Department of Education in United States District Court, Case Nos. CIV S-84-836, and CIV 87-1658.

C. The parties desire to compromise and settle all claims which are, have been, or could have been asserted by plaintiff against defendants.

D. The parties consider the confidentiality of the term of this Settlement Agreement to be a material and fundamental element of the compromise between them. The parties have determined that maintaining the terms of this Settlement Agreement as confidential will serve each of their individual best interests.

E. This Settlement Agreement is not an admission of any liability or wrongdoing by any party, nor shall it be construed or deemed to be evidence of any liability or wrongdoing, nor an admission that plaintiff's claims are without substantial merit.

COVENANTS

NOW, THEREFORE, in consideration of the mutual promises and covenants met forth herein, the parties agree as follows.,

1. The Department agrees object to pay to plaintiff of the sum of $464,000.00 in full and complete satisfaction of his claims. Plaintiff characterizes this payment of $464,000.00 as payment for personal injury damages suffered after plaintiff's discharge on July 14, 1986.

2. Plaintiff may repay his Public Employees Retirement System (PERS) account from the amount he receives as noted in paragraph 1 if PERS permits such repayment. Defendant will not object to a court order providing for plaintiff's reinstatement to his PERS membership upon plaintiff's payment of all sums previously withdrawn from his PERS retirement account.

3. Plaintiff gives up any right he has to reinstatement with the Department and shall make no application for employment to the California Department of Education or compete in any examinations offered by the Department.

4. Any employment inquiry made to the Department about plaintiff shall be referred to the Department Personnel officer. The Personnel Officer shall state that plaintiff was a consultant with the Vocational Education Unit. The Personnel Officer shall also tell the person inquiring that Dr. Xavier Del Buono, who is now retired from the Department was plaintiff's last supervisor and is the appropriate person to speak to regarding plaintiff's work performance.

5. In response to any inquiries concerning this matter, the parties shall state the following:

> The parties have resolved their differences to their mutual satisfaction and neither party admits any wrongdoing. We have no further comment.

The parties and their attorneys agree that no comment other than the above shall be made concerning this matter.

6. Plaintiff agree that he will not enter any building which is occupied solely by the State Department of Education or any office space occupied solely by the State Department of Education without prior written permission from the Department of Education Personnel Officer. The written permission shall be obtained by mail or telecopier.

7. Plaintiff shall immediately upon payment pursuant to Paragraph I dismiss with prejudice in its entirety, this litigation and all other pending litigation, complaints and claims against defendants and any of them.

8. The parties and their attorneys agree that they will keep the terms and amount of this Settlement Agreement completely confidential and that they will not hereafter disclose any information concerning this Settlement Agreement to anyone, regardless of whether that information is accurate or not, except as required to comply with any applicable laws. This provision will not, however, preclude any party from disclosing the fact that the litigation has been "resolved" and that plaintiff is no longer employed by the California State Department of Education.

In the event that either party (including their attorneys) violates the confidentiality provision, they will be liable to the other party in the amount of $20,000.00 for each disclosure as well as the non-disclosing party's reasonable attorneys' fee. The parties agree that the actual amount of damage that would be suffered as a result of breach of this confidentiality provision is dependant upon many circumstances and it, therefore, would be impracticable and difficult to fix the amount of damages. Accordingly, the parties agree that, if the arbitrator finds a breech, the amount of $20,000.00 will be paid as liquidated damages, and not as a penalty or forfeiture.

If on party has a good faith belief that another party has violated this confidentiality provision, which is denied by the allegedly disclosing party, the matter will be subject to binding arbitration before an arbitrator selected by the American Arbitration Association and will be subject to AAA procedures. Prior to any arbitration, the parties shall most and confer informally is an effort to, resolve the matter.

9. In the event that either party violates any provision of this settlement agreement other than the confidentiality provision, that party will be liable to the other up to the amount of $20,000.00 for each breach as well as reasonable attorneys' fees.

If one party has a good faith belief that another party has breached any provision of this Settlement Agreement, which is denied by the other party, the matter will be subject to binding arbitration before and arbitrator selected by the American Arbitration Association and will be subject to AAA procedures. Prior to any arbitration, the parties shall meet and confer informally in an effort to resolve the matter.

10. The federal district court shall maintain jurisdiction for a period of two years for

the purpose of reviewing any arbitration decision made pursuant to paragraphs 8 and 9, if necessary. The parties agree that the public interest, in the terms of this agreement remaining confidential outweighs the public interest, if any, served by their disclosure.

11. Plaintiff, on behalf of himself, his heirs, executors, administrators, successors assigns and the trustee, hereby voluntarily and on the conditions and terms that are specified in this Settlement Agreement, releases and forever discharges the named defendants, California State Department of Education, its officers, managers, employees, agents, attorneys and all others acting an their behalf, from any and all claims, demands, actions and causes of action, of any and every sort, whether known or unknown, which were or could have been asserted in any court for any matter or facts related to this lawsuit or to plaintiff's employment with the California State Department of Education.

12. It is understood and agreed that this is a full and final settlement and release of all unknown, undisclosed and/or unanticipated injuries, debts or damages now known, disclosed and/or anticipated. Having consulted with attorney, plaintiff expressly waives and relinquishes any and all rights and benefits which he now has, or in the future may have, under Section 1542 of the Civil Code of the State of California, which provides:

> A general release does not extend to claims which the creditor does not know or suspect to exist in his favor at the time of executing the release, which if

known by him most have materially affected his settlement with the debtor.

13. It is understood and agreed that this Settlement Agreement and all documents executed in relation thereto are not an admission of any liability and shall not be construed as an admission of liability by any of the defendants, nor shall any of the above be construed or deemed to be evidence of the admission on the part of the parties of any liability or wrongdoing whatsoever. The Settlement Agreement shall not be offered or received in evidence for any purpose other than for the enforcement or interpretation of this Settlement Agreement.

14. Each party is to pay its own costs and attorneys fees.

15. This Settlement Agreement constitutes the entire agreement between the parties and fully supercedes any and all prior agreements and understandings, written or oral, between the parties pertaining to the subject matter hereto.

16. The parties represent and agree that they have reviewed all aspects of this Agreement with their respective attorneys, that they have carefully read and fully understand all the provisions of this Agreement, and that they are voluntarily entering into this Agreement.

17. The parties represent and agree that in executing this Agreement they do not rely and have not relied upon any representation or statement made by any of the parties or by any of the parties' agents, attorneys or representatives with regard to the subject matter, basis or effect of this Settlement Agreement or

otherwise, other than those specifically stated in this written Settlement Agreement.

18. This Settlement Agreement shall be interpreted in accordance with the plain meaning of its terms and not strictly for or against any party hereto.

Dated: May [30,] 1990 /s/ JOHN BANKS
JOHN BANKS, Plaintiff

Dated: May [30,] 1990 /s/ CARLOS M. ALCALA
CARLOS M. ALCALA
Attorney for Plaintiff

Dated: May [30,] 1990 /s/ WILLIAN D. DAWSON
WILLIAM D. DAWSON for
Defendant California
Department of Education

Dated: May [30,] 1990 /s/ JOSEPH R. SYMKOWICK
JOSEPH R. SYMKOWICK
General Counsel
California Department of
Education

SUPERIOR COURT OF THE STATE OF CALIFORNIA
FOR THE COUNTY OF SACRAMENTO

Case No. 748218

VERA JO BANKS, PETITIONER

v.

JOHN W. BANKS, II, RESPONDENTS

[Filed: Sept. 12, 1990]

DECLARATION OF CARLOS ALCALA

I, Carlos Alcala, Declare as follows:

1. I am an attorney at law licensed to practice before all courts in the state of California

2. I represented respondent John W. Banks in a civil action in the United States District Court, Eastern District of California against William Honig, The Department of Education, et al.

3. In May of 1990 the case settled. In June of 1990, a settlement check made payable to both myself and John Banks was received in my office;

4. To date, John Banks has refused to endorse said check stating I am owed fees and cost pursuant to our fee agreement; Accordingly, the check has set in my drawer, losing a considerable amount of interest;

5. The amount of money in dispute (over attorney's fees and costs) is $184.000.00;

6. I have offered to Mr. Banks to put the disputed attorney's fees and costs ($184,000.00) into an interest bearing trust account until our dispute can be resolved through a county bar fee arbitration, and pay the balance to him. This amount of money (the difference between the amount of the settlement and the $184,00.00 I claim is due me) is clearly Mr. Banks money, yet he refuses to endorse the check so I can give him the funds. I am informed and believe that when Mr. Banks receives the proceeds of the settlement, he is under an order to deliver the proceeds of the settlement to Ms. Ossola to be placed in trust;

7. Since it in neither in my interest nor Mr. Bank's interest to have a considerable sum of money sitting in my drawer, I hereby represent that I will do the following:

a. I will endorse the check provided I am permitted to take the sum of $184,000.00 and deposit the same in an interest bearing trust account until my dispute with John Banks is received;

This will protect Mr. Banks' alleged interest in the money in the event it is determined he is owed some portion of the fees and cost in dispute;

b. I will deposit the balance of the funds (representing Mr. Banks' money) with the court clerk.

I declare under penalty of perjury that the foregoing is true and correct and that this declaration was executed on September 11, 1990, at Sacramento, California.

/s/ CARLOS ALCALA
CARLOS ALCALA

UNITED STATES TAX COURT

Nos. 18096-97 and 18097-97

IN THE MATTER OF:
JOHN W. BANKS, II, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

VOLUME I

TRANSCRIPT OF PROCEEDINGS

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reaching a final answer.

Q. All right. When the amount was paid by the State, how was it paid?

A. They gave a check to both of us in one check for the total amount.

MR. WISE: Oh, Your Honor, there is one item that I—this brings to mind, and I want to do this on the record. We withdraw any claim for additional legal fees with respect to Carlos Alcala over and above the amount allowed in the statutory notice. That's now a part of this case.

THE COURT: Counsel?

MS. GROBE: Yes. I understand Petitioner is conceding the claim for the additional $34,000.

Respondent accepts the concession.

THE COURT: Very good. Thank you.

MR. WISE: Thank you.

BY MR. WISE:

Q. Now, would you tell the Court what—so this was put into account with both of your signatures?

A. Yes.

Q. How was that money disbursed? To whom? I'm sorry.

A. There was a court document which directed that those monies that had been borrowed from the PERS [88] retirement fund which I had borrowed for use to pay my legal fees be returned and that PERS would accept it and reenter me back into membership. That amount was something to the point of about 35-, 3,600, something like that.

However, there was, another addition made to that, which was the interest that you must pay on that loan. They had passed a new policy. And so I had to bring up another 1,200-and-some dollars to add to the first check, which was 35—about 600, to the best of my memory

Q. All right.

A. And you added it together it comes very, very close—if not 37,000 is what I'm trying to say. That's close.

Q. Very good. 37—what else was that money paid to?

A. 85,000 went to my ex-spouse, which we'd just got a divorce two years earlier—six years earlier. Then there was monies to my other attorney—

Q. How much?

A. 45,000.

Q. Who was your other attorney?

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A. Loreen McMasters.

Q. What did he do for you to earn the 45,000?

A. He was—he filed the first case in this particular process. Then while the money was in the bank—I believe it was still in the bank—Mrs. Arena, who is a person—employee in the IRS—

Q. Internal Revenue Service.

A. —Internal Revenue Service there in Sacramento, she removed $93,000 from it. Mr. Carlos was my attorney—150,000 legal fees. There was 14,000 that had been taken from my check for what they had alleged to have been misuse of property or something, and after that that's all I know.

Q. You can remember.

Now, I want to talk about Mr. McMaster a little bit more. How much did you say you paid him?

A. From that check, 45,000.

Q. $45,000. Okay. So—

MR. WISE: Your Honor, if I may? In my amendment I asked for additional expenses of the lawsuit, and I'm not withdrawing my amendment asking for it, and I want to make this clear on the record. We are withdrawing any claim for additional payments to Carlos Alcala but we are offering in evidence this testimony on payment to another attorney in the case. I think that's—wanted to be clear on the record that that is what that amendment is for.

UNITED STATES TAX COURT

Nos. 18096-97 and 18097-97

IN THE MATTER OF:
JOHN W. BANKS, II, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

VOLUME II

TRANSCRIPT OF PROCEEDINGS

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dishonest in the way he treated me. He—we had a—I had a contract with him for $185,000 which was just my percentage because I was working on a contingency fee; he wasn't paying me by the hour. I took the case very late, I put a lot of time into it, I mean an exorbitant amount of time. And then when it came to the settlement, he would not sign the check, and he insisted on leaving it unsigned for a long period of time, knowing that it would cause me severe duress.

And it was not until he knew that he had me over a barrel that he said, Okay, we'll go into arbitration—I think John will remember this—and unless you take $150,000, you know, take a $35,000 cut—you know, after you've worked for a person that hard and you've done everything you're supposed to do and you kept your end of the bargain, and they do that type of thing

to you, and then they come back to you and they say, Would you represent me again, I mean, what's any logical, reasonable person going to say? They're going to say no, absolutely not. And then he threatened me because I wouldn't represent him.

Q. Mr. Alcala, I believe you also testified that there was, in your recollection, perhaps a small amount of actual personal injuries, medical damages in this case. Is that correct?

CERTIFIED MAIL

Mr. John Banks
4643 Paula Way
Fair Oaks, California 95628

Re: EEOC Charge Against California State Department of Education
No. 091831406

Dear Mr. Banks:

Because you filed the above charge with the Equal Employment Opportunity Commission, and more than 180 days have elapsed since the date the Commission assumed jurisdiction over that charge, and no suit based thereon has been filed by this Department, and because you have specifically requested this Notice, you are hereby notified that you have the right to institute a civil action under Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. 2000e, *et seq.*, against the above-named respondent.

If you choose to commence a civil action, such suit must be filed in the appropriate United States District Court within 90 days of your receipt of this Notice. If you are unable to retain an attorney, the Court is authorized *in its discretion* to appoint an attorney to represent you and to authorize commencement of the suit without payment of fees, costs, or security. In order to apply for an appointed attorney, you should, *well before the expiration of the above 90-day period*, take this Notice, along with any correspondence you have received from the Justice Department or the Equal Employment Opportunity Commission, to the Clerk of the United States District Court in Sacramento.

The investigative file pertaining to your case is located in the EEOC District Office, 10 United Nations Plaza, 4th Floor, San Francisco, California 94102.

This Notice should not be taken to mean that the Department of Justice has made a judgment as to whether or not your case is meritorious.

Sincerely,

Wm. Bradford Reynolds
Assistant Attorney General
Civil Rights Division

By: HERBERT A. GOLDSMITH, JR.
HERBERT A. GOLDSMITH, JR.
Attorney
Employment Litigation Section

cc: EEOC District Office
California State Department of Education

[Attorneys for Plaintiff Omitted]

IN THE UNITED STATES DISTRICT COURT
EASTERN DISTRICT OF CALIFORNIA

No. CIVS 84 0836 LKK

JOHN BANKS, PLAINTIFF

v.

WILI IAM HONIG, DONALD MCKINLEY, DAVIS CAMPBELL, RICHARD POND, RICHARD MESA, RAMIRO D. REYES, ROBERT A. CERVANTES, TOMAS LOPEZ, JAMES R. SMITH, STATE DEPARTMENT OF EDUCATION, STATE OF CALIFORNIA, DEFENDANTS

SECOND AMENDED COMPLAINT; DEMAND FOR JURY TRIAL

[Filed: Jan. 15, 1986]

Plaintiff Alleges:

JURISDICTION

1. This action arises under the United States Constitution, particularly the Fourteenth Amendment thereof, and under federal law, particularly (a) The Civil Rights Act of 1866, 42 U.S.C. providing for the equal rights of persons in every state and territory within the jurisdiction of the United States to make and enter contracts; and, (b) 42 U.S.C. § 1983, providing for relief against any person who, under color of statute,

deprives another of any rights, privileges, or immunities received by the Constitution and laws, and (c) Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e-2000e-17 providing for relief against discrimination in employment.

Plaintiff brings this action for injunctive relief and damages to compensate him for the economic loss and other damages caused by defendants' unlawful employment practice and acts of harassment committed against plaintiff because plaintiff is a member of the Negro race.

2. Jurisdiction of the Court is invoked pursuant to 28 U.S.C. § 1337 and 1343, and 42 U.S.C. § 2000e-5(f)(3).

3. In addition, this is an action to redress unlawful discriminating employment practices under California Government Code §12965 (Count Three), for damages for intentional infliction of emotional distress arising under California State Law (Count Four), and for slander arising under California State Law (Counts Five and Six).

The actions alleged in Counts Three, Four, Five, and Six, are based on the same operative facts as those giving rise to federal claims set forth in Counts One and Two as hereinafter more clearly appears. Because these actions involve common defendants and matters of proof, judicial economy, convenience, and fairness to the parties herein will result if the Court assumes and exercises jurisdiction of the action for redress of unlawful discriminating employment practices which is alleged in Count Three, intentional infliction of emotional distress which is alleged in Count Four, and for slander which is alleged in Counts Five and Six.

ALLEGATIONS COMMON TO ALL COUNTS

4. Plaintiff is a black male citizen of the United States and a member of the Negro race who has been employed by Defendant State Department of Education since January 1972. Plaintiff resides in Sacramento County, California.

5. Defendants at all times material hereto were duly appointed, employed, and acting officers and supervisorial employees in the California State Department of Education, a Department of the government of the State of California.

6. Defendant William Honig is sued both in his individual capacity and in his capacity as the duly elected California Superintendent of Public Instruction and head of the State Department of Education. Plaintiff is informed and believes and thereon alleges that defendant Honig is a resident of the County of Sacramento, State of California and maintains his principal place of business in said county.

7. Defendants Donald McKinley and Davis Campbell are former employees of the Department of Education. Defendants Richard Pond, Richard Mesa, Ramiro D. Reyes, Robert A. Cervantes, Tomas Lopez, and James R. Smith are all employees of the California State Department of Education and are sued in both their individual and official capacities. Plaintiff is informed and believes that said defendants are all residents of the County of Sacramento, State of California and maintain their principal place of business in said County.

8. Defendant State Department of Education is a department of the State Government of the State of California and is headed by defendant William Honig.

Said Department has its principal place of business in Sacramento, California, and is an agency of defendant State of California and is an employer within the meaning of 42 U.S.C. § 2000e(b) in that it is engaged in an industry effecting commerce and employs more than 15 persons and is an employer within the meaning of Government Code § 12926(c) as the State, a subdivision thereof, or a person acting as an agent of an employer.

9. The unlawful employment practices alleged herein were committed within the State of California, and within the County of Sacramento.

FIRST COUNT

10. Each and all the acts of defendants alleged herein were done under color and pretense of the statutes, ordinances, regulations, customs and usages of the State Department of Education and the State of California, and under the authority of officers as officials and supervisory employees of the State Department of Education.

11. During the time plaintiff was employed by defendant State of California, and defendant—State Department of Education, and during the period September 15, 1982 to June 20, 1984, and continuing, and again during the period June 27, 1983 to June 20, 1984, and continuing, said defendants, and their agents, officers, and employees discriminated against plaintiff with respect to the terms, conditions, and privileges of his employment because of plaintiff's race and color in violation of the Civil Rights Act of 1866, 42 U.S.C. § 1981 and 1983, and in violation of Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e-2(a) and California Government Code §§ 12920 et seq. Such discrimination consisted in part of unfounded complaints and

allegations made by individual defendants Honig, McKinley, Campbell, Pond, Mesa, Reyes, Cervantes, Lopez, and Smith, in their official capacities as plaintiff's supervisors, concerning plaintiff's work; plaintiffs assignments by individual defendants Lopez and Cervantes to perform menial, demeaning, duties or no duties at all; and repeated racial insults and slurs concerning plaintiff, in plaintiffs presence, by individual defendants Reyes, and Mesa. By reason of such unlawful discriminatory treatment, plaintiff has suffered humiliation and has been denied promotional and other professional appointments, all to plaintiff's damage in an amount subject to proof.

12. Defendants and each of them, have committed the following and unlawful additional discriminatory practices toward plaintiff during the period September 9, 1979 through and including September 9, 1981 to and including June 20, 1983, and again during the period June 27, 1983 through and including the date of filing this complaint, and continuing thereafter:

A. Denied plaintiff promotion to a management position on the basis that plaintiff was black and the white employees in the Department did not want to be supervised by a black person.

B. Denied plaintiff promotion to Administrator II position in the Department of Education on the sole basis that plaintiff is black, despite the fact that plaintiff placed number three on the employment list for said position.

C. Placed plaintiff number 26 on a list following an Administrator I Examination in 1982 for the stated reason that plaintiff had no field experience despite the fact that the qualifications and experience required for

such position did not include field experience and despite the fact that other candidates that placed higher on said examination had no field experience. The sole basis that plaintiff was placed number 26 on said list was because plaintiff is black. Other employees that were not black and had lesser qualifications than plaintiff and had no field experience were placed higher on the list.

D. Failed plaintiff in an examination for an Administrator II position in Migrant Education Section on the sole basis that plaintiff is black. Only Hispanic males were deemed to be qualified and passed said examination despite the fact that said Hispanic male candidates did not possess the minimum qualifications in the form of required credentials and experience, while plaintiff met all requirements and satisfied the minimum qualifications and had all required credentials and had the necessary experience.

E. Cancelled an examination for the position of Vocational Education Director. Assistant Superintendent CEA, when plaintiff applied to take such examination on the sole basis that plaintiff is black for the purpose of preventing plaintiff from, competing fairly for such position. Instead the position was filled without an examination and plaintiff was not permitted to participate in competition for the position on the sole basis that plaintiff is black.

F. Prevented plaintiff from attending and participating in seminars, workshops, educational conferences and the like related to plaintiff's area of expertise and assignment in Vocational Education and Migrant Education on the sole basis that plaintiff is black. At the time plaintiff was not allowed to attend such, Hispanic and white employees. were allowed to attend and

participate in such seminars, workshops, and conferences.

G. Removed plaintiff from management of a migrant vocational education project because Hispanic and white employees did not want to work for a black employee.

H. Arbitrarily transferred plaintiff to the Migrant Education section from the Vocational Education section on the sole basis that plaintiff is black.

I. Refused to assign plaintiff a work station when he was assigned to Migrant Education on the sole basis that plaintiff is black. Appropriate work stations were assigned to Hispanic and white employees in Migrant Education.

J. Denied promotions to plaintiff while assigned to Migrant Education Section under a policy which provided for promotion of persons of Hispanic descent only to the exclusion of blacks.

K. Refused to assign plaintiff duties and responsibilities appropriate to his position on the basis that plaintiff is a black man. Other employees that are Caucasian or of Hispanic descent have been assigned duties. Plaintiff was informed by defendants Cervantes, Lopez, and Reyes, that they did not want black persons doing any work on vocational education projects and for such reason plaintiff was not assigned respective duties.

L. Harassed by Hispanic Managers defendants Reyes, Lopez, and Cervantes, of the defendant Department for the sole reason that plaintiff is black. Such activity was authorized, condoned, and ratified by the other named defendants.

M. Defendants Cervantes and Pond monitored plaintiff's activities while assigned under his supervision including noting phone calls, time arrived and time deported and related matters for the reason that plaintiff is black. No similar surveillance was done with respect to white or Hispanic employees. Such activity was authorized, condoned, and sanctioned by defendants Lopez, Smith, Mesa and Honig.

N. Defendants and each of them, employed and authorized surveillance and following of plaintiff at all hours of the day and night to public and private business, including watching plaintiff's house since 1979 and continuing thereafter to the present on the sole basis that plaintiff is black. No similar surveillance was conducted on white and Hispanic employees.

O. Maintained a secret file on plaintiff containing negative comments while no secret file is kept on white employees and while the keeping of a secret file is prohibited by law.

P. Denied plaintiff educational leave with pay on six separate occasions for completion of defendant's Ed. D. program while at the same time granting such leave to white employees of the department.

Q. Terminated plaintiff's daughter, who had independently and without knowledge of plaintiff obtained employment in the defendant Department, for the stated reason that she was related to plaintiff and that related persons could not be employed by the Department. The true reasons why plaintiff's daughter was terminated was because she and plaintiff are black—in that many related white employees are employed by the Department despite being related and have not been terminated under such an alleged policy.

R. Plaintiff is informed and believes and thereon alleges that in addition to the practice enumerated in this paragraph, defendants, and each of them, has engaged in discriminatory practices which are not yet fully known by plaintiff.

13. As a proximate result of the conduct of defendants and each of them, plaintiff necessarily incurred expenses for medical and hospital care in an amount not yet ascertained and subject to proof. Plaintiff is informed and believes and thereon alleges that he will be required to incur medical and hospital expenses in the future in an amount subject to proof.

14. The acts of defendants, and each of them, were arbitrary and capricious and constituted discrimination based upon plaintiff's race and violated plaintiff's rights under the equal protest clause of the Fourteenth Amendment to the United States Constitution.

15. The conduct of defendants and each of them, deprived. plaintiff of the following rights, privileges and immunities secured to him by the Constitution of the United States: the right not to be deprived of life, liberty, or property, without the process of law and the right of equal protection of the laws secured by the Fourteenth Amendment, to the Constitution of the United States, all to plaintiff's general damage in an amount subject to proof.

16. As a direct and proximate result of the wrongful acts by the defendants, and each of them, plaintiff has suffered actual damages in an amount not yet ascertained and subject to proof and will continue to suffer damage for the humiliation and embarrassment caused by defendants and each of them by reason of plaintiff's race and color.

17. The acts, conduct and behavior of defendants and each of them were performed knowingly, intentionally and maliciously by reason of which plaintiff is entitled to an award of punitive damages.

18. Pursuant to Civil Rights Act of 1866, 42 U.S.C. § 1981, et seq., plaintiff seeks to be made whole for back pay from the date he would have been promoted from the present back to September 9, 1979, less interim earnings, in the amount pursuant to applicable law. Pursuant. to the Civil Rights Act of 1866, 42 U.S.C. § 1983, plaintiff seeks damages in order to redress him for the deprivation of rights, privileges, and immunities secured by the Constitution and laws of the United States.

19. Plaintiff also seeks an award of attorneys fees incurred in prosecuting this action pursuant to applicable law.

WHEREFORE, plaintiff prays for relief as hereinafter set forth.

SECOND COUNT

20. Plaintiff has filed a timely charge against defendants with the Equal Employment Opportunity Commission alleging denial of individual rights under Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e-5. The United States Department of Justice, United States Attorney, has given permission to plaintiff to sue defendants pursuant to Title VII of the Civil Rights Act of 1964 by issuing a right to sue notice on April 20, 1984. A true and correct copy of such notice is attached hereto and marked Exhibit A. The allegations of this complaint are within the scope of the charge filed with the Equal Employment Opportunity

Commission and could reasonably have been expected to grow out of the charge filed.

21. This is a proceeding for a declaratory judgment as to plaintiff's rights and for a permanent injunction restraining defendants from maintaining a policy, practice, custom, or usage of discriminating against plaintiff and other black persons because of race with respect to compensation, terms, conditions. and privileges of employment and in ways that deprive plaintiff of equal employment opportunities and otherwise adversely affect his status as an employee because of race. This complaint also seeks restitution to plaintiff of all rights, privileges, benefits, and income that would have been received by him but for defendants' unlawful and discriminating practices.

22. Plaintiff incorporates by reference Paragraphs 10-12 of the First Count as though set forth in full herein.

23. Plaintiff has no plain, adequate or complete remedy at law to redress the wrongs alleged. and this suit for injunctive relief is his only means of securing adequate relief. Plaintiff is now suffering and will continue to suffer irreparable injury from defendants' policy, practice, custom, and usage as set forth herein until and unless enjoined by the Court.

24. Pursuant to Title VII of the Civil Rights Act of 1964, plaintiff seeks to be made whole for back pay from the date he would have been promoted from the present back to September 9, 1981 (two years prior to the date EEOC took jurisdiction of the charge) less interim earnings of amounts comparable, in the amount to be determined by the Court.

25. Plaintiff also seeks an award of attorneys fees incurred in prosecuting this action pursuant to applicable law.

WHEREFORE, plaintiff prays for relief as hereinafter set forth.

THIRD COUNT

26. Plaintiff brings this action pursuant to California Government Code §12965 seeking to obtain redress for unlawful discrimination in employment committed by defendants.

27. Plaintiff has filed a timely charge with the California Department of Fair Employment and Housing in accordance with California Government Code §12960, which department issued a right to sue notice on September 19, 1983, advising plaintiff that he could file suit within one year of the date of such notice.

28. Plaintiff incorporates by this reference Paragraphs 10-12 of the First Count and Paragraph 23 of the Second Count as though set forth in full.

29. The effect of the policies and practices described in paragraphs 11 and 12 of the First Count, as incorporated in this Count, has been, and continues to be, discriminating against black persons such as plaintiff and has jeopardized his job, tended to deprive him of employment opportunities, caused him damage, and otherwise affect his status as an employee, all in violation of California Government Code § 12920, et seq.

30. Pursuant to California Government Code § 12965 plaintiff seeks to be made whole for back pay from the date he would have been promoted to the present, and seeks damages to compensate him for the harm, humiliation, harassment, and discrimination suffered.

31. Pursuant to California Government Code § 12965, plaintiff seeks an award of attorneys fees incurred in prosecuting this action.

FOURTH COUNT

32. Plaintiff incorporates by this reference Paragraphs 10-12 of the First Count as though set forth in full.

33. Defendants' conduct as hereinbefore set forth was intentional and malicious and done for the purpose of causing plaintiff to severe emotional and physical distress. Defendants willfully and maliciously conspired to, and did, in fact, intimidate and humiliate defendant through a series of acts, confrontations, personal and professional insults, racial slurs, and unequal discriminatory employment practices. Defendants knew, or should have known, by reason of his nationality and background, was particularly susceptible to emotional distress from defendants' conduct. Defendants condoned and ratified that conduct with the knowledge that plaintiff's emotional and physical distress, would thereby increase, and was done with a wanton and reckless disregard of' the consequences to the plaintiff.

34. As a further proximate result of the aforementioned acts, plaintiff was required to and did employ physicians and surgeons to examine, treat and care for him, and incurred additional medical expenses for doctors and drugs in an amount which has not yet been ascertained. Plaintiff is informed and believes and thereon alleges that he will incur some additional medical expense, the exact amount of which is unknown. When said sums are ascertained, plaintiff will

seek leave to amend this complaint to insert the true amounts.

35. As a proximate result of the aforementioned acts, plaintiff suffered humiliation, mental anguish, and emotional distress and physical distress and has been impaired in mind and body, all to plaintiffs general damage in the sum of $1,000,000.00 (One Million Dollars).

36. By reason of the aforementioned acts, plaintiff was prevented from attending to his usual occupation and profession as an employee of the Department of Education and as a part time financial consultant, financial planner, life insurance salesman, securities dealer and dealer in partnership interests in real estate partnerships and thereby lost earnings and sustained losses in the total sum of $4,500.000.00 ($4.5 Million).

37. The aforementioned acts of defendants and each of them were willful, wanton, malicious, and oppressive, and justify the awarding of punitive and, exemplary damages in the sum of $1,000,000.00 (One Million Dollars).

WHEREFORE, plaintiff prays for relieve as hereinafter set forth.

FIFTH COUNT

38. During the period April 1980 to June 20, 1984, and continuing and again within the period beginning within one year prior to the filing of this action, defendants Pond, Cervantes, Mesa, Reyes, and Campbell stated the following concerning plaintiff: Plaintiff was dishonest, was a schemer, committed illegal acts, was a liar, was going to jail, could not be trusted, and

materials to conduct private business, was unqualified, and incompetent. Such statements were and are false.

39. The words were heard by fellow employees of the Department of Education, and existing and potential business clients of plaintiff at that time.

40. These words were slanderous per se because they charge the plaintiff with being convicted and punished for committing a crime ("he is going to jail"), and further charge plaintiff with the crime of theft and obtaining property by false pretenses.

41. The words were understood by those who saw and heard them in a way in which defamed plaintiff because those that were clients of plaintiff cancelled their business relationship with plaintiff and those who were not clients refused to enter into business relationships with plaintiff.

42. As a result of the above described words, plaintiff has suffered general damages to his reputation in the amount of subject to proof.

43. As a further proximate result of the above described words plaintiff has suffered the following special damages:

A. His life insurance sales license was cancelled to plaintiff's damage in an amount subject to proof.

B. His NASD securities salesperson license was cancelled to plaintiffs damage in an amount subject to proof.

C. His partnership interest in real property investments were destroyed to plaintiff's damage in an amount subject to proof.

D. He lost profits from business that was cancelled all to plaintiff's damage in the sum of $4,500,000.00 ($4.5 Million).

44. As a further proximate result of the above described words, plaintiff has suffered mental anguish and emotional distress and was injured in his mind and body incurred medical and hospital expenses, incurred expense from doctors and drugs to his damage in an amount not fully ascertained. When said sums are ascertained, plaintiff will seek leave to amend this complaint to insert the true amount.

45. The above described words were spoken by defendants Pond, Reyes, Cervantes, and Campbell, knowing that they had no cause to believe the statements, and were made with the intent to disgrace plaintiff because of their feelings of hatred and ill will toward the plaintiff and with a desire to oppress plaintiff. Thus, the awarding of punitive and exemplary damages in the amount of $1,000,000.00 (One Million Dollars) is justified.

WHEREFORE, plaintiff prays for relief as hereinafter set forth.

SIXTH COUNT

46. Plaintiff incorporates by reference paragraphs 4-8 of the First Count as though set forth in full herein.

47. During the period April 1980 to June 20, 1984, and continuing, and again within the period beginning within one year prior to the filing of this action, defendants Pond, Cervantes, Mesa, Reyes, and Campbell stated the following concerning plaintiff: Plaintiff was dishonest, was a schemer, committed illegal acts, was a liar, was going to jail, could not be trusted,

improperly used State time and materials to conduct private business, was unqualified, and incompetent. Such statements were and are false.

48. The words were heard by fellow employees of the Department of Education, and existing and potential business clients of plaintiff at that time.

49. These words were slanderous per se because they tend to injure plaintiff in his profession and business as a financial planner, securities dealer, life insurance salesperson, and salesman of partnership interest in real estate partnerships by imputing to him theft, dishonesty, other illegal acts, and being a liar which tends to generally disqualify him from the practice of such professions and businesses and has a natural tendency to lessen the profits of the plaintiff's profession and business as a financial planner, securities dealer, life insurance salesman and salesman of partnership interests in real estate partnerships.

50. As a result of the above described words, plaintiff has suffered general damages to his reputation in the amount of $1,000,000.00 (One Million Dollars).

51. As a further proximate result of the above described words, plaintiff has suffered the following special damages:

A. His life insurance sales license was cancelled;

B. His NASD securities salesperson license was cancelled;

C. His partnership interests in real property investments were destroyed;

D. He lost profits from business that was cancelled all to plaintiff's damage in a sum subject to proof.

52. As a further proximate result of the above described words, plaintiff has suffered mental anguish, and emotional distress and was injured in his mind and body, incurred medical and hospital expenses, incurred expenses for doctors and drugs, all to his damage in an amount not fully ascertained. When said sums are ascertained, plaintiff will seek leave to amend this complaint to insert the true amount.

53. The above described words were spoken by defendants Pond, Cervantes, Reyes, and Campbell, knowing that they had no cause to believe the statements, and were made with the intent to disgrace plaintiff because of their feelings of hatred and ill will, towards the plaintiff and with a desire to oppress plaintiff and thus the awarding of punitive and exemplary damages in the amount of $1,000,000.00 (One Million Dollars) is justified.

WHEREFORE, plaintiff requests the following relief be granted:

ON THE FIRST COUNT

1. For general damages for violation of plaintiff's constitutional rights.
2. For medical and hospital expenses in an amount subject to proof;
3. For future medical and hospital expenses in an amount subject to proof;
4. For punitive and exemplary damages In an amount determined by the trier of fact;

5. For reasonable attorneys fees incurred in the prosecution of this action;

6. For costs of suit herein incurred;

7. For such other and further relief that the Court may deem just and proper.

ON THE SECOND AND THIRD COUNTS

1. An order requiring defendants and each of them to promote plaintiff to the position of Administrator II, in the State Department of Education;

2. An order requiring defendants, and each of them, to make whole by appropriate back pay and related employee benefits, and damages to plaintiff because of being adversely affected by discrimination on account of race in the part of defendants;

3. For general damages to compensate plaintiff for the harm, humiliation, and discrimination suffered in an amount according to proof;

4. An order granting plaintiff a preliminary and permanent injunction restraining defendants, their agents, successors, employees, attorneys, and all others acting in concert with defendants or under defendants' direction from discriminating on the basis of race or color, and requiring them to undertake remedial action to eradicate any effects of past discrimination;

5. An order awarding reasonable attorneys' fees and costs; and,

6. An order granting such further relief as the court deems proper.

ON THE FOURTH COUNT

1. For general damages in the sum of $1,000.000.00 (One Million Dollars);

2. For medical, hospital and related expenses according to proof;

3. For lost earnings and losses sustained in the sum of $1,000,000.00 (One Million Dollars);

4. For exemplary and-punitive damages in the sum of $1,000,000-00 (One Million Dollars);

5. For costs of suit herein incurred;

6. For such other and further relief that the court may" deem just and proper.

ON THE FIFTH COUNT

1. For general damages to plaintiff's reputation in the sum of $1,000,000.00 (One Million Dollars);

2. For special damages for lost profits and losses sustained in the sum of $4,500,000.00 ($4.5 Million);

3. For medical, hospital, and related expenses according to proof;

4. For exemplary and punitive damages in the sum of $1,000,000.00 (One Million Dollars);

5. For costs of suit herein incurred;

6. For such other and further relief that the Court may deem just and proper.

ON THE SIXTH COUNT

1. For general damages to plaintiff's reputation in the sum of $1,000,000.00 (One Million Dollars);

2. For special damages for lost profits and losses sustained the sum of $4,500,000.00 ($4.5 Million);
3. For medical, hospital, and related expenses according to proof;
4. For exemplary and punitive damages in the sum of $1,000,000.00 (One Million Dollars);
5. For costs of suit herein incurred:
6. For such other and further relief that the Court may deem just and proper.

DATED: January 14, 1985

LOREN E. MCMASTER
Attorney for Plaintiff

DEMAND FOR JURY

Plaintiff demands trial by jury on the issues in this complaint that are triable of right by jury.

DATED: January 14, 1985

LOREN E. MCMASTER
Attorney for Plaintiff

I declare that:

I am (a resident of employed in) the county of Sacramento California.
(County where mailing occurred)

I am over the age of eighteen years and not a party of the within entitled cause, my business/residence address is 900 G Street, Suite 2, Sacramento, California 95814

On January 15, 1985, I served the attached SECOND
(Date)
AMENDED COMPLAINT; DEMAND FOR JURY TRIAL on the other parties in said cause, by placing a true copy thereof enclosed in a sealed envelope with postage thereon fully prepaid, in the United States mail a t Sacramento, California address as follows.

Margaret Rodda
Deputy'Attorney General
1515 K Street, Suite 511
Sacramento, California 95814

I declare under penalty of perjury that the foregoing is true and correct, and that this declaration was executed on January 15, 1985, at Sacramento California.
[DATE] [PLACE]

TRACI ZAVALA /s/ TRACI ZAVALA
[TYPE OR PRINT NAME] SIGNATURE

UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 02-70421

SIGITAS BANAITIS, ET AL., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE,
RESPONDENT

DOCKET ENTRIES

DATE	PROCEEDINGS
3/13/02	DOCKETED CAUSE AND ENTERED APPEARANCES OF COUNSEL. CADS SENT (Y/N): n. setting schedule as follows: Fee payment is due 3/27/02; record is due 4/16/02; petitioner's opening brief is due 5/28/02; respondent's brief is due 6/25/02; optional reply brief is due 7/9/02; [02-70421] (tm) [02-70421]
	* * * * *
2/14/03	ARGUED AND SUBMITTED TO Robert R. Beezer, Sidney R. Thomas, Richard R. Clifton [02-70421] (pi) [02-70421]
	* * * * *

DATE	PROCEEDINGS
8/27/03	FILED OPINION: AFFIRMED IN PART, REVERSED IN PART. (Terminated on the Merits after Oral Hearing; Other; Written, Signed, Published. Robert R. Beezer; Sidney R. THOMAS, author; Richard R. Clifton.) FILED AND ENTERED JUDGMENT. [02-70421] (je) [02-70421]
10/24/03	MANDATE ISSUED [02-70421] (je) [02-70421]

* * * * *

UNITED STATES TAX COURT

Docket No. 4323-00

SIGITAS BANAITIS, ET AL., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

DOCKET ENTRIES

DATE	DOCKET NUMBER	PROCEEDINGS
04/18/00	0001	PF PETITION Filed: Fee Paid R 04/19/00
04/18/00	0002	DPT DESIGNATION of Trial at Portland, ORR 04/19/00
06/07/00	0003	ACS ANSWER (C/S 06/02/00).
09/08/00	0004	NTD NOTICE of Trial on 02/12/01 at Portland, OR. B 09/08/00 C

DATE	DOCKET NUMBER	PROCEEDINGS
09/08/00	0005	SPTO STANDING PRE-TRIAL ORDER attached to Notice of Trial B 09/08/00 C
10/10/00	0006	MOTP MOTION by petr. to Amend Petition. (Amd. Pet. Ld.) (C/S 10/6/00 GR 10/11/00 B 10/12/00 C)
10/11/00	0007	AP AMENDED PETITION R 10/12/00
11/14/00	0008	AAP ANSWER TO AMENDED PETITION (C/S 11/13/00).
02/12/01	0009	TRL TRIAL before Judge Gerber at Portland, OR; Also called 2/14. OPENING BRIEFS DUE: 5/15/01; REPLY BRIEFS DUE: 6/29/01; SUBMITTED TO JUDGE GERBER SUB 02/14/01
02/14/01	0010	STP STIPULATION OF FACTS w/Ex. (PTO)
03/12/01	0011	TRAN TRANSCRIPT of 2/14/01 rec'd. (TRL)
05/16/01	0012	BFR BRIEF for resp. (p.m.t.) P O5/21/0l C

DATE	DOCKET NUMBER	PROCEEDINGS
05/21/01	0013	BFP BRIEF for petr. C/S 5/15/01 (p.m.t.)
06/19/01	0014	RBFP REPLY BRIEF for petr. R 06/29/0l
06/29/01	0015	RBFR REPLY BRIEF for resp. P 06/29/0l C
01/08/02	0016	MOP MEMORANDUM OPINION, Judge Gerber T.C. Memo. 2002-5 (Decision B will be entered for Resp.) 01/08/02 C
01/10/02	0017	DEC DECISION ENTERED, Judge Gerber B 01/10/02 C
		APPELLATE PROCEEDINGS
03/07/02	0018	NOAP NOTICE OF APPEAL by petr. to U.S.C.A., 9th Cir. C/S 02-25-02. FEE PAID. B 03/08/02 C
03/08/02	0019	NOFC NOTICE of Filing with copy of Not. of App. sent to the parties. B 03/08/02 C

UNITED STATES TAX COURT

Docket No. 4323-00

SIGITAS BANAITIS, ET AL., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[Filed: Oct. 6, 2000]

AMENDED PETITION

Pursuant to 26 USC 6213(a), 26 USC 6214, and United States Tax Court Rule 34, petitioner, Sigitas J. Banaitis, hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in the Commissioner's notice of deficiency [service symbols AP:PNW:POR:90D:JOW:MH] dated March 24, 2000, and, as a basis for his case and the petition, alleges as follows:

1. (a) Petitioner, Sigitas J. Banaitis, is an individual with a current mailing address of:

23939 S.W. Gage Road
Wilsonville, Oregon 97070-6707.

(b) Petitioner's taxpayer identification number is 359-28-0184

c) Petitioner's individual federal income tax return, form 1040, for the tax year at issue, 1995, was timely filed with the Office of the Internal Revenue Service at the Service Center in Ogden, Utah.

2. The notice of deficiency, a copy (including all applicable schedules) of which is attached and marked as exhibit A, was mailed to petitioner on March 24, 2000, and was issued by the Internal Revenue Service Portland Appeals Office in Portland, Oregon.

3. The alleged deficiency in federal income tax is as follows:

Year	Alleged Deficiency
1995	$1,708,216.

The entire alleged deficiency is in dispute.

4. The alleged increases in tax set forth in the notice of deficiency are based on the following errors:

(a) an increase in taxable income in the amount of $6,682,139 for proceeds from a personal injury lawsuit;

(b) an increase in itemized deductions in the amount of $3,317,316 for lawyer fees belonging to the contingent fee lawyer;

(c) a decrease in itemized deductions attributed to the itemized deduction limitation in the amount of $219,568;

(d) an increase in alternative minimum tax in the amount of $288,798.

5. The facts upon which petitioner relies as a basis for his petition are as follows:

(a) All amounts received by petitioner as damages for past and future wages were received on account of personal injuries based on a claim for tort and tort

type rights and are properly excluded from gross income under 26 USC 104 (a) (2) (1989).

(b) All amounts received by petitioner as punitive damages were received on account of physical personal injuries based on a claim for tort and tort-type rights; and are properly excluded from gross income under 26 USC 104(a) (1989).

(c) All amounts received directly by petitioner's lawyer from the defendants of the lawsuit pursuant to a contingency fee agreement between petitioner and his; lawyer and the settlement agreement among petitioner, his lawyer, and the defendants are not gross income to petitioner under 26 USC 61 or under any other provision of law.

6. As an additional defense to respondent's notice of deficiency, petitioner alleges that the imposition of tax as set forth in respondent's notice of deficiency would violate the fifth amendment to the United States Constitution as a violation of due process of law and as taking of private property for public use without just compensation.

WHEREFORE, petitioner prays for a judgment of this court determining that the alleged deficiency is in error, determining that there is no income tax deficiency and that no further tax is due, and determining that petitioner has properly reported all income and paid all tax in accordance with the laws of the United States.

Respectfully submitted,

DATED: 06 Oct. 00

/s/ MICHAEL C. WETZEL
MICHAEL C. WETZEL, WM0539

/s/ JOSEPH WETZEL
JOSEPH WETZEL, WJ0903

/s/ [Signature Illegible]
RUSSELL A. SANDOR, SR 1076

Wetzel DeFrang & Sandor
300 Dayton Building
838 S.W. First Avenue
Portland, Oregon 977204
(503) 220-0299

INTERNAL REVENUE SERVICE
Western Region

DEPARTMENT OF THE TREASURY
Internal Revenue Service
Portland Appeals Office, MS0680
1220 S.W. Third Avenue
Room 1117
***Portland, OR* 97204**

AP: PNW:POR:90D:JOW:MH

S.S.N./E.I.N.: 359-28-0184
Person to Contact:
Mr. John O. Weiler

Contact Person Identification Number: 9-94880
Telephone number: (503) 326-2483
Last Day to File Petition with the United States Tax Court:
[JUN 22 2000]

Date: [MAR 24, 2000]

Sigitas J. Banaitis,
23939 S.W. Gage Road
Wilsonville, OR 97070-6707

CERTIFIED MAIL

Tax Year(s) Ended	**Increase In Tax**
December 31, 1995	$1,709,216.00

NOTICE OF DEFICIENCY

Dear Mr. Banaitis:

We determined that you owe an additional amount, as shown above. This letter is your **NOTICE OF DEFICIENCY**, as required by law. The enclosed statement shows how we figured the deficiency.

If you want to contest this deficiency in court before making any payment, you have 90 days from the above mailing date of this letter (150 days if addressed to you outside the United States) to file a petition with the United States Tax Court for a redetermination of the deficiency. To get a petition form and the rules for filing a petition, write to: United States Tax Court, 400 Second Street, NW, Washington, D.C. 20217.

Send the completed petition form, a copy of this letter and a copy of all statements and schedules you received with this letter to the Tax Court at the same address.

The time you have to file a petition with the Court (90 or 150 days) is fixed by law. The Court cannot consider your case if you fille the petition late.

If this letter is addressed to both husband and wife, and both want to petition the Tax Court, both must sign and file the petition or each must file a separate, signed petition. If only one of you petitions the Tax Court, the full amount of the deficiency will be assessed against the non-petitioning spouse.

Small Tax Cases

The Tax Court has a simplified procedure for small tax cases, when the amount in dispute is $50,000 or less for any one tax year. You can get information about this procedure, as well as a petition form, by writing to the Clerk of the United States Tax Court at the court address shown in the second paragraph above. You should write promptly if you intend to file a petition with the court.

If you decide not to file a petition with the Tax Court, please sign and return the enclosed waiver form. This will permit us to assess the deficiency quickly and will limit the accumulation of interest. The enclosed envelope is for your convenience.

If you are a "C" corporation, under Internal Revenue Code Section 6621(c) , large corporate underpayments may be subject to a higher rate of interest than the normal rate of interest for underpayments.

If you decide not to sign and return the waiver, and you don't file a petition with the Tax Court within the time limit, the law requires us to assess and bill you for the deficiency after 90 days from the above mailing date (150 davs if this letter is addressed to you outside the United States).

If you have questions about this letter, you may call or write to the person whose name is shown above. If the telephone number is outside your local calling area, you will be charged for a long distance call. If you write, please attach a copy of this letter to help us identify your account. Also, include your daytime telephone number so we can call you if necessary.

You also have the right to contact the office of the Taxpayer Advocate. However, you should first contact the person whose name and phone number are shown above since that person has direct access to your tax information resulting in this notice and can answer questions or concerns you might have. You can call 1-800-829-1040 and ask for a Taxpayer Advocates assistance. Or you can contact the Taxpayer Advocate for your local area. The local Taxpayer Advocate's address is 1220 S.W. Third Avenue, Mail Stop 0-405, Portland, Oregon 97204. The phone number is (503) 326-2333. Taxpayer Advocate assistance cannot be used as a substitute for established IRS procedures, formal appeals processes, etc. The Taxpayer Advocate is not able to reverse legal or technically correct tax determinations, nor extend the time fixed by law that you have to file a petition in the U.S. Tax Court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels, gets prompt and proper handling.

Sincerely,

CHARLES O. ROSSOTTI
Commissioner
by

/s/ Signature illegible
LES L. LUCAS
Associate Chief

Enclosures:
Copy of this letter
Waiver
Statement
Envelope

CC: Joseph Wetzel.

FORM 5278 (Rev 5-92)	**Department of the Treasury – Internal Revenue Service Statement – Income Tax Changes**	Schedule: 1	
		Form No: 1040	
Name of Taxpayer: **Sigitas J. Banaitis** SSN/EIN: 359-28-01134	_XX_ Notice of Deficiency ___ Other ___ Settlement Computation		
	Tax Years Ended		
1. Adjustments to Income:	12/31/1995		
a) Litigation Award	$6,682,139.00		
b) Miscellaneous itemized Deductions	($3,317,316.00)		
c) Itemized Deductions Limitation	$219,568.00		
d)			
e)			
f)			
g)			
h)			
i)			
2. Total Adjustments	$3,584,391.00	$0.00	$0.00
3. Taxable Income As Shown In:			
Return as Filed	$1,465,622.00	$0.00	$0.00
4. Taxable Income As Revised	$5,050,013.00	$0.00	$0.00

Schedule 1—Continuation:

5. Tax Computed From: Tax Rates – Married Filing Separate – Schedule 2	$1,987,649.00	$0.00	$0.00
6. Alternative Tax - Schedule 2	$1,987,153.00		
7. Corrected Tax Liability	$1,987,153.00	$0.00	$0.00
8. Less Credits: a) b) c)			
9. Balance	$1,987,153.00	$0.00	$0.00
10. Other Taxes: a) Alternative Minimum Tax b) c)	$288,798. 00		
11. Total Corrected Tax Liability	$2,275,951.00	$0.00	$0.00
12. Total Tax Per Return as Filed	$567,735.00	$0.00	$0.00
13. Increase or (Decrease) in Tax	$1,708,216.00	$0.00	$0.00
14. Additions to Tax:			

Form

Sigitas J. Banaitis **Schedule 2**
SSN: 359-28-0184
Tax Year 1995

Computation of Tax

Regular Tax:

Taxable income from Schedule 1	$5,050,013.00
Tax bracket income	$128,250.00
Marginal income	$4,921,763.00
Marginal tax rate	39.6%
Marginal tax rate	$1,949,018.00
Tax on tax bracket income	$38,631.00
Total regular tax	$1,987,649.00

Alternative tax

1.	Taxable Income from Schedule 1	$5,050,013.00
2.	Lesser of long-term gain or net capital gain	$4,272.00
3.	Line 1 less line 2	$5,045,741.00
4.	Alternative amount based on filing status	$40,100.00
5.	Greater of line 3 or line 4	$5,045,741.00
6.	Line 1 less line 5	$4,272.00
7.	Tax on line 5 using tax rate schedules	$1,985,957.00
8.	Line 6 multiplied by 28%	$1,196.00
9.	Line 7 plus line 8	
	Alternative Capital Gain Tax	$1,987,153.00

Schedule 2—Continuation:

Taxable income from Schedule 1	$5,045,741.00
Tax bracket income	$128,250.00
Marginal income	$4,917,491.00
Marginal tax rate	39.6%
Marginal tax rate	$1,947,326.00
Tax on tax bracket income	$38,631.00
Total regular tax	$1,985,957.00

Sigitas J. Banaitis **Schedule 3**
SSN: 359-28-0184
Tax Year 1995

Miscellaneous Itemized Deductions

1.	Miscellaneous expenses per return	$1,503.00
2.	Additional attorney fees allowable	$3,478,929.00
3.	Total expenses as corrected	$3,480,432.00
4.	Limitation (2.0% of adjusted gross income)	$163,116.00
5.	Allowable deduction (line 1 less line 2, but not less than $0.00)	$3,317,316.00

Computation of adjusted gross income:

Adjusted gross income per return or as previously adjusted	$1,473,685.00
Adjustments affecting adjusted gross income:	$6,682, 139.00
1(a) Litigation Award	
Adjusted gross income as corrected	$8,155,824.00

Computation of Allowable Attorney Fees:

Total amount taxable	$5,646,389.00
Total amount received	$6,271,389.00
Taxable percentage (taxable amount/total received)	0.900341057
Total paid attorney	$3,864,012.00
Taxable percentage	0.900341057
Allowable expenses	$3,478,929.00

Sigitas J. Banaitis **Schedule 4**
SSN: 359-28-0184
Tax Year: 1995

Computation of Itemized Deduction Limitation

1.	Medical and dental expenses	$0.00
2.	Taxes	$10,515.00
3.	Interest	$12,416.00
4.	Charitable contributions	$8,518.00
5.	Miscellaneous deductions	$3,317,316.00
6.	Total itemized deductions	$3.348,765.00
7.	Investment interest	$2,217.00
8.	Line 6 less line 7	$3,346,548.00
9.	80% of line 8	$2,677,238.00
10.	Adjusted cross incorne as corrected	$8,155.824.00
11.	Exclusion	$57,350.00
12.	Line 10 less line 11	11$8,098,474.00
13.	Line 13 multiplied by 3%	$242,954.00
14.	Lesser of lines 9 or 13	$242,954.00
15.	Allowable itemized deductions	$3,105,811.00
16.	Claimed per return (after adjustments)	$3,325,379.00
17.	Increase to taxable income	$219,568.00

Computation of adjusted gross income:

Adjusted gross income per the return	$1,473,685.00
Adjustments to AGI:	
1(a) Litigation Award	$6,682,139.00
Adjusted gross income as corrected	$8,155,824.00

Sigitas J. Banaitis **Schedule 5**
SSN: 359-28-0184
Tax Year: 1995

Computation of Alternative Minimum Tax

Part I - Adjustments & Preferences

1)	Standard Deduction (if you fternized deductions entered $0)	$0.00
2)	Medical & Dental. Enter smaller of Sch A line 4. or 2.5% of AGI	$0.00
3)	Taxes from Schedule A	$10,515.00
4)	Certain Interest on Home Mortgage	$0.00
5)	Misc Itemized: Deductions. Sch A line 26	$3,317,316.00
6)	Refund of Taxes (enter as negative number)	($245.00)
7)	investment Interest	$0.00
8)	Post '86 Depr. Difference between regular and AMT Depr.	$0.00
9)	Adjusted Gain or loss. Difference between regular and AM T	$0.00
10)	Incentive Stock Options	$0.00
11)	Passive Activities. Difference between Regular and AMT	$0.00
12)	Beneficiaries of Estates and Trusts	$0.00
13)	Tax Exempt Interest for private activity bonds	$0.00
14)	Other:	

Schedule 5—Continuation:

A)	Contributions	$0.00	
b)	Circulation Expenditures	$0.00	
c)	Depletion	$0.00	
d)	Pre '87 Depreciation	$0.00	
e)	Installment Sales	$0.00	
f)	Intangible Drilling Costs	$0.00	
g)	Long-Term contracts	$0.00	
h)	Loss Limitations	$0.00	
i)	Mining Costs	$0.00	
j)	Patrons Adjustment	$0.00	
k)	Pollution Control	$0.00	
l)	Research & Experiment	$0.00	
m)	Tax Shelter Farm	$0.00	
n)	Related Adj's	$0.00	
			0.00
15)	Total Adjustments and Preferences		3,327,586.00

Part II - Alternative Minimum Taxable Income

16)	Form 1040 line 35. (AGI less itemized Deductions)	$5,050,013.00
17)	Net Operating Loss Deduction	$0.00
18)	If AGI is over $114,700 ($57,350 for MFS) and you itemized deductions, enter amount from line 9 of worksheet for Sch A, line 28	$242,954.00)
19)	Combine lines 15 through 18	$8,134,645.00
20)	Alternative Tax Net Operating Loss Deduction	$0.00
21)	Alternative Minimum Taxable Income. Line 19 less line 20	$8,134,645.00

Schedule 5—Continuation:

Part III - Exemption Amount and Alternative Minimum Tax

22) Exemption Amount:

If your filing status is:	And line 21 in not over:	
Single or Head of Household	$112,500.00	$33,750.00
Married Filing Joint	$150,000.00	$45.000.00
		$0.00
Married Filing Separately	$75,000.00	$22,500.00

Line 22 Amount:

$0.00

If line 21 is over the amount shown above, see instructions

23) Subtract line 22 from line 21	$8,134,645.00
24) If line 23 is $175,000 or less ($87,500 if MFS), multiply line 23 by 26%. Otherwise multiply line 23 by 28% and subtract $3,500 ($1,750 if MFS)	
25) Alternative Minimum	$2,275,951.00
Foreign Tax Credit	$0.00
26) Tentative Minimum Tax Line 24 less line 25	$2,275,951.00
27) Regular Tax Liability less Foreign Tax Credit	$1,987,153.00
28) ALTERNATIVE MINIMUM TAX. Line 26 less line 27	$288,798.00

Schedule 5—Continuation:

EXEMPTION WORKSHEET

1) Enter $33,750 ($45,000 if MFJ. $22,500 if MFS)	$45,000.00
2) Enter AMTI (line 21 from form 6251)	$8,134,645.00
3) Enter $112,500 ($150,000 if MFJ. $75,000 if MFS)	$150,000.00
4) Subtract line 3 from line 2. Not less than $0.	$7,984,645.00
5) Multiply line 4 by 25%	$1,996,161.25
6) Subtract line 5 from line 1. Not less than $0	$0.00

Sigitas J. Banaitis
SSN: 359-28-0184
Tax Year: 1995

Explanation of Adjustments

1(a) LitigationAward

It is determined that the taxable proceeds from your lawsuit against **Bank of California, N.A.** and **Mitsubishi Bank, LTD** are $8,103,559.00 rather than $1,421,420.00 for the taxable year 1995. The proceeds totaling $8,728,559.00 (which includes interest of approximately $2,550,484.00) are taxable to the extent of $8,103,559.00. All income is taxable unless it is specifically excludable. It has not been established that any amount greater than $625,000.00 is excludable. Accordingly, taxable income is increased $6,682,139.00 for the taxable year 1995.

1(b) Miscellaneous Itemized Deductions

It is determined that the allowable deduction for miscellaneous itemized deductions is $3,317,316.00 rather than $0.00 for the taxable year 1995. Attorney fees of $3,864,012.00 were incurred in connection with the litigation award in adjustment 1 (a), above. The total attorney fees have been prorated to the taxable portion of the award with $3,478,929.00 being allowable as a miscellaneous expense subject to the two percent of adjusted gross income limitation. Further, as a result of the adjustment made in 1(a), above, adjusted gross income has been increased thus increasing the two percent of adjusted gross income limitation. Accordingly, taxable income is decreased $3,317,316.00 for the taxable year 1995. See Schedule 3 for computation.

1(c) Itemized Deductions Limitation

It is determined that the allowable total Itemized deductions for the taxable year 1995 is $3,105,811.00 rather than $3,325,379.00 (total amount allowed after correction for adjustment 1(b), above)). As a result of the changes caused by adjustments 1(a) and 1(b), above, itemized deductions, adjusted gross income and the itemized deductions threshold for limiting itemized deductions have been recomputed as shown in Schedule 4. Accordingly, taxable income is increased $219,568.00 for the taxable year 1995.

10(a) Alternative Minimum Tax

It is determined that the alternative minimum tax is $288,798.00 rather than $0.00 for the taxable year 1995. As a result of adjustments 1(a), 1(b) and 1(c), above, the alternative minimum taxable income and alternative minimum tax has been recomputed as shown in Schedule 5. Accordingly, alternative minimum tax is increased $288,798.00 for the taxable year 1995.

UNITED STATES TAX COURT

Docket No. 4323-00

SIGITAS BANAITIS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

STIPULATION OF FACTS

It is hereby stipulated that, for the purpose of this case, the following statements may be accepted as facts and all exhibits referred to herein and attached hereto may be accepted as authentic and are incorporated in this stipulation and made a part hereof; provided, however, that either party has the right to object to the admission of any such facts and exhibits in evidence on the grounds of relevancy and materiality, but not on other grounds unless expressly reserved herein, and provided, further, that either party may introduce other and further evidence not inconsistent with the facts herein stipulated.

1. The petitioner, Sy Banaitis, resided in Clackamas County, Oregon, when he filed his petition in this case.

2. Attached hereto as Exhibit 1-J is a copy of the statutory notice mailed to Sy Banaitis on March 24, 2000.

3. Attached hereto as Exhibit 2-J is a copy of Sy Banaitis' timely filed federal income tax return for the taxable year 1995.

4. From 1980 to December 30, 1987, Sy Banaitis was employed as a Vice president and loan officer of the Bank of California, N.A., in Portland, Oregon. In 1984, the Mitsubishi Bank, Ltd., a member of the Mitsubishi Group, acquired a controlling interest in the Bank of California, N.A.

5. In 1986 and 1987, employees of the Mitsubishi Bank, Ltd., asked Sy Banaitis to disclose confidential information concerning privately held companies, which were his loan customers, and which competed against firms and enterprises of the Mitsubishi Group, the parent of the Mitsubishi Bank, Ltd. Sy Banaitis refused, to avoid violating his ethical and legal duties, confidentiality agreements, and Bank of California policy.

6. Employees of Mitsubishi Bank, Ltd., including Sy Banaitis' immediate supervisor, prepared negative performance evaluations, making accusations against the his integrity.

7. On December 30, 1987, Sy Banaitis was forced to leave his position at the Bank of California, N.A.

8. On November 15, 1989, Sy Banaitis retained the law firm of Merten and Associates to file a lawsuit against the Bank of California, N.A., and the Mitsubishi Bank, Ltd.

9. Attached hereto as Exhibit 3-J is a copy of the attorneys' fees agreement, which Sy Banaitis entered into with the firm of Merten and Associates.

10. The firm of Merten and Associates agreed to represent Sy Banaitis in a lawsuit against the Bank of California, N.A., and the Mitsubishi Bank, Ltd.

11. On December 12, 1989, Sy Banaitis filed a lawsuit against the Bank of California, N.A., and the Mitsubishi

Bank, Ltd., Case No. A8912-07357, in the Multnomah County Circuit Court for the State of Oregon. Attached hereto as Exhibit 4-J is a copy of the fourth amended complaint filed in that proceeding.

12. On March 18, 1991, the jury returned a verdict against the Bank of California, N.A., and the Mitsubishi Bank, Ltd., a copy of which is attached hereto as Exhibit 5-J. The judgment, reflecting the jury's verdict is attached hereto as Exhibit 6-J.

13. The Bank of California, N.A., and the Mitsubishi Bank, moved the trial court for a judgment notwithstanding the verdict. The motion was granted in part, setting aside the verdicts for punitive damages. Attached hereto as Exhibit 7-J is a copy of the judgment, reflecting the judgment notwithstanding the verdict.

14. On June 20, 1991, Sy Banaitis appealed to the Oregon Court of Appeals.

15. On July 22, 1991, Sy Banaitis entered into an attorneys' fees agreement with the firm of Merten and Associates, a copy of which is attached as Exhibit 8-J, to cover the attorneys' fees for the appeal.

16. On August 3, 1994, the Oregon Court of Appeals entered a decision which reinstated the jury's verdict. Attached hereto as Exhibit 9-J is a copy of the court's opinion.

17. On October 26, 1995, Sy Banaitis entered into a settlement agreement with the Bank of California, N.A., and the Mitsubishi Bank, Ltd. A copy of the settlement agreement is attached as Exhibit 10-J. Attached as Exhibits 11-J and 12-J are copies of the checks made payable to Sy Banaitis and to Charles J. Merten, respectively.

18. The parties stipulate to the admissibility of the following exhibits:

Exhibits No.	Description
1-J	Notice of deficiency
2-J	Sy Banaitis' 1995 income tax return
3-J	Attorneys' fee agreement, dated 11/15/89
4-J	Fourth amended complaint
5-J	Jury verdict
6-J	Judgment, reflecting verdict
7-J	Judgment, reflecting judgment notwithstanding the verdict
8-J	Attorneys' fee agreement, dated 7/22/91
9-J	Opinion of the Oregon Court of Appeals
10-J	Settlement agreement, dated 10/26/95
11-J	Check payable to Sy Banaitis
12-J	Check payable to Charles merten
13-J	Sy Banaitis' authorization to release medical records to Merten and Associates, dated 11/15/89
14-J	Sy Banaitis' general authorization for release of hospital, medical, and other records to Merten and Associates, dated 11/15/89

Exhibits No.	Description
15-J	Letter from Charles Merten to David W. Waldram, M.D.
16-J	Letter from Charles Merten to William Winans, D.O.
17-J	Letter from Charles Merten to Robert Berselli, M.D.
18-J	Letter from Charles Merten to Roger J. Miller, R.P.T.
19-J	Testimony of Edward Colbach in case of Banaitis v. Mitsubushi Bank, Ltd. and Bank of California
20-J	Jury instructions in case of Banaitis v. Mitsubishi Bank, Ltd. and Bank of California, N.A.
21-J	Memorandum Opinion of Oregon Supreme Court
22-J	Letter from Charles Merten to Theodore Kulongoski
23-J	Internal Revenue Service Form 1099-MISC instructions for 1995
24-J	Internal Revenue Service Publication, 907 for the year 1995

Exhibits No.	Description
25-J	Letter Interpretation between Sy Banaitis and Charles Merten, dated 7/22/91

RICHARD W. SKILLMAN
Acting Chief Counsel
Internal Revenue Service

/s/ JOSEPH WETZEL
JOSEPH WETZEL
Counsel for petitioner
Tax Court No. WJ0903
Wetzel DeFrang & Sandor
300 Dayton Building
838 S.W. First Avenue
Portland, OR 97204
Tel . No. (503) 220-0299

Dated: [Feb. 7, 2001]

By: [Stamp of SHIRLEY M. FRANCIS]
SHIRLEY M. FRANCIS
Attorney (SBSE)
Tax Court No. FS0247
620 S.W. Main Street, Ste. 312
Portland, OR 97205
Tel . No.(503) 326-3186

Dated: [Feb. 8, 2001]

CONTINGENT FEE RETAINER AGREEMENT

(Statutory Attorneys Fees)

The Client, Sy Banaitis, retains the law firm of Merten & Associates to represent Client in connection with: The Bank of California and others.

We agree as follows:

1. **Attorneys Fees.** The attorneys fees to be paid to the law firm of Merten & Associates shall be a percentage of the gross recovery, as follows:

a. If a settlement is reached prior to the start of a trial, arbitration, hearing, or other proceeding, then one-third (33-1/3%) of the gross recovery shall be paid as the attorney fee.

b. If a trial, arbitration, hearing, or other proceeding has **started** and a settlement, judgment, or other recovery thereafter occurs, then forty percent (40%) of the gross recovery shall be paid as the attorney fee.

For purpose of this agreement, a proceeding "starts" when, on the day that it is scheduled, any activity involving a judge or arbitrator is begun, including a conference.

2. **Statutory Attorneys Fees.** There is a chance that a court may award you statutory attorneys fees to be paid by the other side. If such an award is made, it will be credited towards what you owe under paragraph (1), Attorney shall keep the excess.

3. **Appeal.** Attorney does not now agree to represent Client on an appeal. If Client and Attorney, agree in the future to pursue or defend an appeal, we will negotiate a

separate fee for the appeal. Under ordinary, circumstances, any contingent fee on appeal would **be no less than** an additional ten percent (10%) of the recovery.

4. **Structured Settlement.** If all or part of the recovery is based upon a structured settlement, the attorneys fee shall be based on the present cash value of the total recovery. If Client chooses not to structure Client's portion of a settlement, Attorney is nonetheless authorized to accept a structured payment of the attorneys fee directly from the adverse party.

5. **Expenses.** The Client shall pay any and all out-of pocket expenses incurred on behalf of the Client by Merten & Associates in pursuing this claim. Client shall be billed monthly for expenses and Client shall pay the same within ten days of billing. If not so paid, Client agrees that interest at 9% per annum may be charged to Client. Any, unpaid expenses and interest at the time of recovery shall be deducted from the Client's share of any recovery. If there is no recovery, the Client remains responsible to reimburse the attorney for all expenses advanced on behalf of the Client, plus interest. Attorney will consult with Client prior to incurring any single expenditure of $1,000 or more.

6. **Settlement Consultations.** Any settlement offer will be discussed with Client. Attorney will obtain Client's approval before acceptance or rejection of a settlement on Client's behalf.

7. **Termination.** If the Client fails or refuses to comply with the terms of this agreement, to make payment of the expenses or interest when due, to cooperate in the preparation of the claim, unreasonably rejects a bonafide settlement offer, or insists on pursuing a claim which, in the attorney's opinion, does not warrant

further effort, then Merten & Associates may terminate its services. In the event of termination, Attorney is entitled to the reasonable value of the professional services rendered and to reimbursement of any outstanding expenses and interest. Client agrees that the reasonable value of Mr. Merten's services is $175.00 per hour.

8. **No Guarantee.** Client acknowledges that Attorney makes no guarantee or representation regarding the successful termination of the above matter.

9. **Attorney's Discretion.** Attorney has complete discretion to use staff and/or consultants for all work assignments.

10. **Bankruptcy.** If Client files for or is subjected to proceedings, Attorney shall be entitled, as a fee, to no less than $175.00 per hour for all professional time on this matter.

11. **Collection.** In the event it is necessary to place this agreement in the hands of any agency or attorney for collection due to failure to pay fees, expenses or interest when due, it is agreed that reasonable attorneys fees are to be paid to the prevailing party for all legal work done.

12. **Full Discussion.** Client hereby acknowledges that Client has read and received a copy of this Agreement. Attorney has explained its terms and has answered any questions Client has concerning this Agreement and allowed Client a reasonable period of time to consider its terms and conditions before signing it.

13. **Cancellation. Client may rescind and cancel this agreement upon giving written notice to Merten & Associates within two business days of the date below.**

Client acknowledges receipt of a copy of this Agreement.

MERTEN & ASSOCIATES CLIENT

BY: /s/ CHARLES MERTEN /s/ SY BANAITIS

Date: Nov. 15, 1989

ADDENDUM

For purposes of paragraphs 7 and 10 of this agreement, it is agreed that Attorney's current reasonable and hourly rates are:

Charles J. Merten:	$175.00 per hour
Karen L. Fink:	140.00 per hour
David Paul:	100.00 per hour
Paralegals:	40.00 per hour

CHARLES MERTEN
Attorney

Date: [11-15-89]

/s/ SY BANAITIS
Client

Date: [Nov. 15, 1989]

FEE AGREEMENT

This agreement is between Sigitas Banaitis ("Client") and Charles J. Merten ("Attorney"), this agreement acknowledges past services of Attorney on behalf of Client and defines the terms of future services.

A. **Pre-Appeal Events & Agreements:**

1. Attorney represented Client in a lawsuit against Mitsubishi Bank, Ltd. (MBL) and the Bank of California, N.A. (BCal) for Wrongful Termination and Intentional Interference with Contract. On March 18, 1991 a jury returned a verdict in favor of Client in the total amount of $6,271,389.

2. Under the fee agreement between Client and Attorney with respect to Attorney's services through trial (the "First Agreement"), Client and Attorney agree that Attorney was and is entitled to 40% of the gross recovery against MBL and BCal for Attorney's services through trial, plus 40% of the accumulated interest on such gross recovery through date of collection. Client and Attorney agree that under the First Agreement, "gross recovery" means the total amount payable by MBL and BCal regardless of to whom paid. Further, Client and Attorney agree that under the First Agreement, Attorney is entitled to reimbursement from Client for any and all expenses advanced by Attorney on behalf of Client.

3. On April 1, 1991 a judgement ("Original Judgment") in the amount of $6,271,389 was entered against MBL and BCal but said judgment was set aside on May 24, 1991 by the trial court and a new judgment ("JNOV") in the amout of $1,271,389 was entered on that date. The JNOV is for compensatory damages only, as the trial

court set aside the $5,000,000 awarded by the jury for punitive damages.

4. The jury verdict and Original Judgment awarded $1,146,389 in compensatory damages and $3,000,000 in punitive damages against MBL. The jury verdict and Original Judgment awarded $771,389 in compensatory and $2,000,000 in punitive damages against BCal. MBL and BCal were jointly and severally liable for $646,389 of the compensatory damages and severally liable for the balance of the respective awards against them.

5. Client and Attorney agree that, as to the jury verdict and Original Judgment amount, Attorney is entitled to $2,508,555.60 in fees for services rendered through trial, plus all accumulated interest on that amount.

6. Client and Attorney agree that, as of May 30, 1991, Client owes Attorney $10,157.93 with respect to expenses advanced by Attorney on behalf of Client.

7. Client and Attorney had understood and agreed, and hereby ratify, that under First Agreement Attorney's total fee was to be paid first out of any punitive damage award, and that not until said punitive damage award, if any, was exhausted would Attorney's fee be paid out of any compensatory damages award and that to the extent that any of Attorney's total fees were payable out of a compensatory damage award, the full amount so payable would come first from any economic damage award and secondly from any noneconomic damage award.

8. MBL and BCal have applied from the JNOV. It is anticipated that they will argue, among other things, that they have no liability to Client whatsoever and, therefore, owe him nothing.

9. Client authorized Attorney to file an appeal from the JNOV, which was done June 20, 1991. On appeal, Client will seek to have all or part of the punitive damages award reinstated, and will seek to hold on to all the compensatory damage award.

10. Client and Attorney have discussed the "appeal" process. For purposes of this agreement, "appeal" means review by the Oregon Court of Appeal of the JNOV, any attempt by either Client or MBL and BCal to have the Oregon Supreme Court review the JNOV and/or decision of the Oregon Court of Appeals, and any attempt by Client or MBL and BCal to have the United States Supreme Court review the JNOV and/or decision of the Oregon Court of Appeals and/or decision of the Oregon Supreme Court. "Appeal" does not, for purposes of this agreement, include any appellate process after a remand for retrial, nor does it include services at a retrial.

11. The First Agreement did not set the terms of Attorney's compensation for services in connection with the appeal which is now pending and Client and Attorney are creating this agreement, in part, in order to set those terms.

B. **Client and Attorney Hereby Agree as Follows with Respect to Compensation of Attorney in Light of his Additional Services on Appeal:**

1. If the jury verdict and/or Original Judgment is fully reinstated, Attorney shall receive as his fee $2,691,224 plus the accumulated interest on said $2,691,224 through date of collection. Said fee shall be payable from the punitive damages.

2. If the JNOV is affirmed in whole or in part and no punitive damages are recoverable by Client, Attorney shall receive 50% of the compensatory damages payable by MBL and/or BCal, plus 50% of the accumulated interest due through date of collection.

3. If the jury verdict and/or Original Judgment is fully reinstated as against MBL but no damages are recoverable as against BCal, Attorney shall received $1,860,576 plus accumulated interest on said $1,860,576 through date of collection. Said fee shall be payable from punitive damages.

4. If the jury verdict and/or Original Judgment is fully reinstated as against BCal but no damages are recoverable as against MBL, Attorney shall received $1,243,950 plus accumulated interest on said $1,243,950 through date of collection. Said fee shall be payable from punitive damages.

5. If the jury verdict and/or Original Judgment is fully reinstated as against MBL but only the existing compensatory damages are recoverable as against BCal, Attorney shall receive $1,923,077 plus the accumulated interest on the said $1,923,077 through date of collection. Said fee shall be payable from the punitive damages.

6. If the jury verdict and/or Original Judgment is fully reinstated as against BCal but only the existing compensatory damages are recoverable as against MBL, Attorney shall receive $1,493,950 plus the accumulated interest on said $1,493,950 through date of collection. Said fee shall be payable from the punitive damages.

C. **Client and Attorney Further Agree as Follows:**

1. Client is to pay on or before August 2, 1991 all reimbursed sums Attorney has advanced on behalf of

Client. As of this date, said sums are $10,500, more or less a few dollars.

2. Starting on October 1, 1991, and on the first day of each month thereafter until the appeal is concluded, client is to pay $500.00 to Attorney towards expenses related to the appeal. Attorney will place said sums into a trust account and is authorized to draw therefrom as expenses are advanced on behalf of Client. Attorney will itemize said expenses and provide client the itemization. Client will not have to pay the $500 in any month following a month where, on the 25th day of the latter, Client's trust account balance was $1,500.00 or more.

3. If a judgment is affirmed or entered against MBL and/or BCal after the appeal, Attorney's services on appeal are hereby deemed to include, and be limited to, efforts to collect said judgment only in Oregon. If collection work is required to be done in other states or countries, or if other attorneys or entities are hired to collect on the judgment within or without the State of Oregon, Attorney and Client shall share the cost of such services in proportion to their then percentage interests in judgment amount sought to be collected.

4. If Client terminates Attorney's services before Client's first brief is filed in the Oregon Court of Appeals, it is agreed that Attorney is entitled to 40% of whatever the total sum MBL and/or BCal is or becomes obligated to pay to or on behalf of Client and/or the State of Oregon and/or Client's attorneys, plus accumulated interest on said 40%, plus $175 per hour for all attorney time of Charles J. Merten & Associates from and after May 24, 1991.

5. If Client terminates Attorney's services after Client's first brief is filed in the Oregon Court of Appeals,

it is agreed that Attorney is entitled to all the compensation described and/or agreed to in paragraphs B above and C(7) below.

6. Attorney may, at his discretion, retain or hire other attorneys to assist him with the appeal. If Attorney does so, client shall not be responsible for compensating said attorneys, and Attorney shall compensate them out of his own pocket and/or by sharing his fee due under this agreement; provided, however, that if paragraph C(4) applies, then such other attorneys shall receive their standard hourly rates from Client (not to exceed $175/hour).

7. (a) If all or part of the case is remanded by an appellate court for retrial, Attorney agrees to retry case for client.

(b) If such a remand occurs and thereafter the case is retried or settled by Attorney, Attorney is entitled to a fee equal to 50% of all sums allocated to compensatory damages and accumulated interest thereon, and 42.9127263% of all sums allocated to punitive damages and accumulated interest thereon; and said fee shall be payable first out of any and all sums allocated and recovered on account of punitive damages and then, and only then, out of other forms of recovery.

(c) If Attorney, because of death or incapacity, is not capable of retrying the case after full or partial remand and Client is thereby required to retain new counsel for a retrial, and said new counsel tries or settles the case, then as to those damages and sums at issue after remand new counsel shall be given his share of the recovery, and Client and Attorney shall allocate the balance in accordance with paragraph C(7)(b).

8. If Client's case is settled prior to the final court decision in the appeal process describe in paragraph A(10) above, the Attorney shall be compensated as followed:

(a) If the case is settled prior to Client's first brief being filed in the Oregon Court of Appeals, Attorney shall receive 40% of whatever total sum, including interest, the case is settled for, plus $175 hour for all Attorney time from and after May 24, 1991;

(b) If the case is settled after Client's first brief is filed in the Oregon Court of Appeals, Attorney shall receive all compensation described and/or agreed to in paragraph B above.

9. Client hereby acknowledges that he has read and received a copy of this Agreement. Attorney has explained its terms and has answered any questions Client has concerning this Agreement and allowed Client a reasonable period of time to consider its terms and conditions before signing it.

10. Paragraph B, C(5), C(7), and C(8) set out a contingent fee agreement for services on appeal and possible retrial. Client may rescind and cancel said contingent fee agreement upon giving written notice to Merten & Associates with two business days of the date below.

Dated: [July 22, 1991] /s/ SY BANAITIS
SIGITAS BANAITIS

Dated: [7-22-91] /s/ CHARLES J. MERTEN
CHARLES J. MERTEN

LETTER INTERPRETATION

On this date Sigitas Banaitis (Banaitis) and Charles J. Merten (Merten) are simultaneously executing a fee agreement concerning Merten's compensation with respect to the case of (*Banaitis v. Mitsubishi Bank, Ltd., et, al.*, Mult. Co. Cir. Ct. Case No. A8912-07357, CA A70113). This case currently is on appeal. One significant point of the fee agreement is the acknowledgment by both Banaitis and Merten that Merten's to-date earned share of whatever is payable now or in the future by Mitsubishi Bank, Ltd. and/or the Bank of California is 40%, including 40% of any accumulated interest, on whatever judgment is eventually approved or settlement made.

Another significant, aspect of the fee agreement executed today is the setting of Merten's over-all compensation, including his compensation for appeal work; under various hypothetical results of the appeal. Banaitis and Merten hereby agree that the correct interpretation of the fee agreement is that Merten is entitled to the sums set forth in that agreement under the described hypotheticals even if the State of Oregon objects and/or is successful in objecting to the fact or manner in which we have made Merten's fee payable out of any punitive damage recovery and even though the fee agreement says that Merten's total fees are payable, in some instances, out of the punitive damage recovery. Banaitis acknowledges and agrees that Merten makes no warranty, promise, representation, or agreement that the State of Oregon will object and/or will not successfully object to our making Merten's total fee payable out of punitive damages in some of the hypotheticals. Banaitis also acknowledges and agrees that no part of Merten's fee is dependent upon the failure of the State of Oregon

to object or successfully object to the way we have agreed Merten is to be paid in the fee agreement. Banaitis agrees that Merten is entitled to the sums set forth in the fee agreement as payable to Attorney even though the State of Oregon, or a judge or a court requires that Banaitis take less and allows the State of Oregon to take more as a result of ORS 18.540.

The fee agreement discusses many hypothetical recoveries after appeal. Banaitis and Merten agree that, whatever the result and whether the result be unforeseen or foreseen, the correct interpretation of the simultaneous fee agreement is that Merten is to get 50% of all payable compensatory damages and 42.9127263% of all payable punitive damages, regardless of to whom payable, plus accumulated interest on those respective amounts from whatever date the law allows client to start accumulating interest.

The interpretations set out in this Letter Interpretation govern and control any other possible interpretation of the provisions of the Fee Agreement between Banaitis and Merten concurrently signed this date.

Dated: [July 22, 1991] /s/ SY BANAITIS
SIGITAS BANAITIS

Dated: [7-22-91] /s/ CHARLES J. MERTEN
CHARLES J. MERTEN

SETTLEMENT AGREEMENT
and
MUTUAL RELEASE

This agreement is made on the *26* day of October, 1995 between Sigitas Banaitis and Mitsubishi Bank, Ltd. and Bank of California, N.A., referred to hereafter as "the Banks," with the intent of resolving all disputes between Banaitis and the Banks.

Banaitis brought an action in the Circuit Court of the State of Oregon for Multnomah County, No A8912-07357 against the Banks. In his Fourth Amended Complaint, he asserted tort claims involving emotional distress, punitive damages and economic loss. He obtained a judgment notwithstanding the verdict against the Banks in the amount of $1,271,389 in compensatory damages, with interest to commence on March 26, 1991. On appeal to the Court of Appeals, the verdict for $3,000,000 against Mitsubishi Bank and $2,000,000 against Bank of California for punitive damages was ordered to be reinstated. The Supreme Court of Oregon allowed the Banks' petition for review, but later dismissed review as improvidently granted. The Banks have moved for a stay of judgment to allow a petition for certiorari to be filed in the United States Supreme Court challenging the validity of the award of punitive damages. The Appellate Judgment of the Oregon Supreme Court has not yet issued.

The parties desire to resolve and compromise their dispute by a payment of money by the Banks to Banaitis and to his attorney in an amount which reflects a compromise on punitive damages and by the dismissal of the action by Banaitis. In addition Banaitis agrees that a portion of the settlement payment should be made

directly to his attorney, Charles J. Merten, in payment of attorney fees earned by Merten as a result of this matter.

THEREFORE, the parties agree as follows:

1. On October 26, 1995, the Banks will pay to Banaitis and Charle J. Merten, attorney for Banaitis, their cashier's check in the total amount of $8,728,559. If the payment is made on a later day, there will be added to the total payment the sum of $1,546 per day after October 26, 1995. If the payment is made on an earlier date, $1, 546 per day will be deducted from the amount.

A Bank of California, N.A., cashier's check made payable to Charles J. Merten in payment of attorney fees in the amount of $3,864,012 (plus or minus his pro rata share of interest adjustments described in this section I) and a Mitsubishi Bank, Ltd., cashier's check made payable to Sigitas Banaitis in the amount of $4,864,547 (plus or minus his pro rata share of interest adjustment described ill this section I) shall be delivered to the payees upon execution of this agreement.

2. Banaitis' action against the Banks will be dismissed without entry of judgment. If the court does not allow vacation of the judgment notwithstanding the verdict, then Banaitis or his attorney, Charles J. Merten, will acknowledge that it has been satisfied. Banaitis and the Banks will execute and file all documents reasonably necessary to accomplish this result.

3. The Banks, Banaitis and his attorney, Merten, promise that they will keep the amount of this settlement confidential. Banaitis and Merten may inform the Justice Department of the State of Oregon insofar as is necessary to comply with the law relating to punitive damages. Upon dismissal of the action or receipt of satisfaction is provided in paragraph 2, the Banks may notify the

Oregon Department of Justice that the case has been settled and refer the department to attorney Merten for further information. The Banks, Banaitis and Merten may inform their employees and agents designated to carry out the terms of this agreement. They may inform their spouses, their attorneys, then accountants and then financial planners and investment counselors in confidence and they may inform taxing authorities as necessary. Other than those exceptions, they may reveal the amount of this settlement only as required by law. These are the only exceptions to the promise of confidentially.

4. Upon execution of this document and the payment of the settlement funds as specified in paragraph 1, Banaitis and the Banks mutually release each other and their respective agents, employees, successors, assigns and affiliated organizations from any and all claims or liability, known, relating to Banaitis' employment and termination by the Banks.

5. This agreement may be signed by the parties in counterpart originals

/s/ SY BANAITIS
SIGITAS BANAITIS

/s/ CHARLES J. MERTEN
CHARLES J. MERTEN
personally and as attorney for Sigitas Banaitis

Mitsubishi Bank, Ltd

by /s/ SHOTA YASUDA
SHOTA YASUDA,
Executive Vice President
North American Headquarters

Bank of California, N. A.

by /s/ MICHAEL T. CONNELL
MICHAEL T. CONNELL
Vice President

Banaitis Settlement

Amount of Settlement	$8,728,559
Contingent Lawyer Fee	<$3,864,012>
Litigation expenses	<$ 30,000>
	$4,834,547
Tax paid in 1996 for interest on settlement (federal and state)	<$ 679,624>
	$4,154,923
Amount paid to State of Oregon in settlement under ORS 18.540 (punitive damage splitting statute)	<$ 150,000>
	$4,004,923
Tax demanded by Internal Revenue Service	<$1,708,216>
	$2,296,707
Tax demanded by State of Oregon	<$ 195,051>
	$2,101,656
Legal fees for State of Oregon issue and federal and state taxes	< $ 117,578>
	$1,984,078

Supreme Court, U.S.
FILED
JUN 14 2004
OFFICE OF THE CLERK

Nos. 03-892 and 03-907

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN W. BANKS, II

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SIGITAS J. BANAITIS

ON WRITS OF CERTIORARI
TO THE UNITED STATES COURTS OF APPEALS
FOR THE SIXTH AND NINTH CIRCUITS

BRIEF FOR THE PETITIONER

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QUESTION PRESENTED

Whether, under Section 61(a) of the Internal Revenue Code, 26 U.S.C. 61(a), a taxpayer's gross income from the proceeds of litigation includes the portion of his damages recovery that is paid to his attorneys pursuant to a contingent fee agreement.

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In the Supreme Court of the United States

No. 03-892
COMMISSIONER OF INTERNAL REVENUE, PETITIONER
v.
JOHN W. BANKS, II

No. 03-892
COMMISSIONER OF INTERNAL REVENUE, PETITIONER
v.
SIGITAS J. BANAITIS

ON WRITS OF CERTIORARI
TO THE UNITED STATES COURTS OF APPEALS
FOR THE SIXTH AND NINTH CIRCUITS

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the court of appeals in No. 03-892 (*Banks*) (Pet. App. 1a-33a) is reported at 345 F.3d 373. The opinion of the Tax Court (Pet. App. 34a-57a) is unofficially reported at 81 T.C.M. (CCH) 1219.

The opinion of the court of appeals in No. 03-907 (*Banaitis*) (Pet. App. 1a-17a) is reported at 340 F.3d 1074. The opinion of the Tax Court (Pet. App. 18a-33a) is unofficially reported at 83 T.C.M. (CCH) 1053.

JURISDICTION

The judgment of the court of appeals in No. 03-892 (*Banks*) was entered on September 30, 2003. The

petition for a writ of certiorari was filed on December 19, 2003. The judgment of the court of appeals in No. 03-907 (*Banaitis*) was entered on August 27, 2003. On November 14, 2003, Justice O'Connor extended the time within which to file a petition for a writ of certiorari to and including December 29, 2003, and the petition for a writ of certiorari was filed on December 24, 2003. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY PROVISIONS INVOLVED

Section 61(a) of the Internal Revenue Code, 26 U.S.C. 61(a), and Section 87.445 of the Oregon Revised Statutes are reprinted in the appendix to this brief. App., *infra*, 1a-2a.

STATEMENT

The courts of appeals in these cases held that a taxpayer can avoid inclusion of a portion of litigation proceeds in his gross income by entering into a contingent fee agreement with his attorney. Well established principles of federal tax law make clear, however, that the entire taxable amount of litigation proceeds is includable in a taxpayer's gross income, regardless of whether he has directed that a portion of those proceeds be paid directly to his attorney under a contingent fee agreement.

No. 03-892. 1. Respondent John W. Banks, II, worked as an educational consultant for the California Department of Education from 1972 until 1986, when his employment was terminated. In response to his termination, respondent filed a civil action against the state agency and various of its past and present employees in the United States District Court for the Eastern District of California. He claimed (i) that his termination violated state and federal prohibitions

against employment discrimination (42 U.S.C. 1981, 1983; Cal. Gov't Code § 12965 (West Supp. 2003)); and (ii) that, in connection with his termination, the defendants committed slander and intentional infliction of emotional distress. Respondent sought general damages, future medical and hospital expenses, punitive and exemplary damages, back pay and related employee benefits, an injunction, and attorney's fees. Respondent's attorney agreed to represent him in the action for a contingent fee.[1] Pet. App. 2a.

Prior to trial, respondent abandoned his state law tort claims. Pet. App. 3a. On May 30, 1990, after trial had begun, respondent entered into an agreement to settle all of his remaining employment discrimination claims against the defendants for $464,000. Pursuant to the contingent fee agreement, respondent paid $150,000 of the settlement proceeds to his attorney. *Id.* at 4a-5a.

Respondent did not include any of the $464,000 settlement proceeds in his gross income on his 1990 federal income tax return. Pet. App. 5a. On audit, the Commissioner determined that the entire amount of the settlement proceeds constituted gross income to respondent under 26 U.S.C. 61(a). The Commissioner further determined that the amount payable to his attorney pursuant to the contingent fee agreement was a deductible expense in earning that income but, since attorney's fee expenses fall within the category of "miscellaneous itemized deductions," they are not deductible in computing the alternative minimum tax (AMT). See 26 U.S.C. 56(b)(1)(A)(i). As a consequence of these determinations, a tax deficiency in the amount

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[1] The contingent fee agreement was not made part of the record here, but its terms are not disputed. Similarly, it is undisputed that the agreement was executed in California.

of $10,625 was issued for respondent's AMT liability. Pet. App. 35a.[2]

2. Respondent sought review of the Commissioner's determinations in the Tax Court. See J.A. 5-8. The Tax Court agreed with the Commissioner that respondent was required to include the entire settlement proceeds in his gross income, including the portion paid to his attorneys as a contingent fee. The court therefore sustained the Commissioner's determination of respondent's AMT liability. Pet. App. 49a-52a.

3. a. The court of appeals affirmed the Tax Court's holding that the portion of the damages retained by respondent represented taxable income to him. Pet. App. 8a-17a. The court of appeals, however, reversed the Tax Court's decision that respondent was required to include in his gross income the portion of the settlement proceeds paid to his attorney under the contingent fee agreement. Pet. App. 17a-25a.

The contingent fee agreement involved in this case was made under California law. In *Benci-Woodward* v. *Commissioner*, 219 F.3d 941 (2000), cert. denied, 531 U.S. 1112 (2001), the Ninth Circuit held that, "[u]nder California law, an attorney lien does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients." *Id.* at 943. The Ninth Circuit therefore concluded that the portion of the damages paid to the attorneys under a contingent fee agreement

[2] In addition, the Commissioner determined that the portion of the damages award that respondent received and retained was taxable income that is not exempt from tax as a recovery for "personal injuries" under Section 104 of the Code, 26 U.S.C. 104 (2000 & Supp. I 2001). The courts below upheld that determination. Pet. App. 8a-17a; see *United States* v. *Burke*, 504 U.S. 229, 239-241 (1992).

in California was part of the gross income of the plaintiff.

In the present case, the Sixth Circuit accepted the Ninth Circuit's holding in *Benci-Woodward* that "California's lien statute confers no ownership interest on attorneys" and that "[c]ontingent fee contracts do not operate to transfer a part of the cause of action to the attorney but only give him a lien upon his client's recovery." Pet. App. 23a (quoting *Benci-Woodward*, 219 F.3d at 943 (internal quotation marks omitted)). The Sixth Circuit disagreed, however, with the ultimate conclusion reached by the Ninth Circuit in *Benci-Woodward*. The court stated that it instead found "persuasive" the reasoning of the Fifth Circuit in *Srivastava* v. *Commissioner*, 220 F.3d 353 (2000), that the federal tax consequences of a contingent fee "do[] not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state." Pet. App. 23a-24a (quoting *Srivastava*, 220 F.3d at 364). The Sixth Circuit stated that "[w]e likewise are not inclined to draw distinctions between contingency fees based on the attorney's lien law of the state in which the fee originated." *Id.* at 24a. Given the variations in state law treatment of attorney's liens, "such a 'state-by-state' approach would not * * * provide sufficient notice to taxpayers as to our tax treatment of contingency-based attorneys fees paid from their respective jury awards." *Ibid.*

The Sixth Circuit had previously held in *Estate of Clarks* v. *United States*, 202 F.3d 854 (2000), that the portion of a lawsuit recovery paid as contingent attorney's fees in Michigan should be excluded from the plaintiff's gross income. The Sixth Circuit concluded in this case that *Estate of Clarks* did not "primarily rest on the rationale that separate state lien laws governing

attorneys' rights determine the correct characterization of an attorney contingency fee." Pet. App. 25a. Accordingly, the court concluded that *Estate of Clarks* was controlling here, "notwithstanding the difference in Michigan's and California's respective attorney's lien laws." *Ibid.* The court made clear that, under its view of the law, there was no need for "protracted inquiries into 'the intricacies of an attorney's bundle of rights.'" *Ibid.* (quoting *Srivastava*, 220 F.3d at 364).

The court thus concluded that the $150,000 portion of respondent's recovery that was paid to his attorney as a contingent fee was not part of his gross income and therefore not subject to tax under the Internal Revenue Code. Pet. App. 25a.

b. Judge Moore dissented on the ground that "California law, as explained by the California Supreme Court and the Ninth Circuit [in *Benci-Woodward*], clearly treats the attorney's contingency-fee contract as simply a security interest and not as an ownership interest." Pet. App. 32a. Accordingly, she concluded that "the proceeds the taxpayer paid to his attorney as a contingency fee should be included in the taxpayer's income." *Ibid.*

No. 03-907. 1. From 1980 until late 1987, respondent Sigitas J. Banaitis, an Oregon resident, worked as a vice president and loan officer for the Bank of California. In his job, respondent had access to confidential financial information regarding the loan customers with which he worked. To ensure the security of this information, respondent and the Bank of California executed confidentiality agreements. Pet. App. 1a-2a.

In 1984, Mitsubishi Bank acquired a controlling interest in the Bank of California. Mitsubishi Bank's parent company controlled and operated firms that competed with a number of respondent's loan customers. In

anticipation of the potential exposure of sensitive financial information that could result from the acquisition, respondent's loan customers requested that he keep their financial information confidential. Respondent complied with their wishes, and he refused to disclose confidential data when asked to do so by employees of Mitsubishi Bank and the Bank of California. Pet. App. 2a.

Soon thereafter, respondent received a performance review at the Bank of California that accused him of dishonesty and improper conduct. After that review, he was placed on probation by the Bank. By December 1987, his work situation had grown intolerable and he left his job. Pet. App. 2a-3a.

2. In November 1989, respondent retained attorneys to pursue legal action against Mitsubishi Bank and the Bank of California. Respondent entered into a contingent fee agreement with his attorneys. Under the agreement, the attorneys were to receive one-third of any recovery prior to commencement of a trial or arbitration and forty percent thereafter. Pet. App. 3a.

Respondent filed a lawsuit against Mitsubishi Bank and the Bank of California in state court in Oregon. His suit alleged that Mitsubishi Bank intentionally and willfully interfered with his employment agreement with the Bank of California, and further alleged that the Bank of California had wrongfully discharged him and improperly attempted to force him to breach his fiduciary duty to his customers. Pet. App. 4a.

The state court jury found in respondent's favor on his wrongful discharge and tortious interference with contract claims. The jury awarded respondent $196,389 for lost compensation and $450,000 for lost future compensation; a total of $625,000 for "noneconomic" damages attributable to emotional distress and injury to

reputation; and a total of $5 million in punitive damages. The defendants were held to be jointly and severally liable for the economic damages award and severally liable for their portions of the noneconomic and punitive damages awards. Pet. App. 4a-5a.

3. In response to post-trial motions, the trial court set aside the punitive damages award against each defendant. All parties then appealed to the Oregon Court of Appeals. Pet. App. 5a. In connection with the appeal, respondent entered into a second fee agreement with his attorneys. Under that revised agreement, the attorneys were to receive, as compensation for their services, 50% of all compensatory damages and 42.9% of all punitive damages. *Ibid.*

4. The Oregon Court of Appeals affirmed the award of compensatory damages and reversed the trial court order that set aside the jury's punitive damages award. *Banaitis* v. *Mitsubishi Bank, Ltd.*, 879 P.2d 1288 (1994). Mitsubishi Bank and the Bank of California then sought review in the Oregon Supreme Court, which initially granted review but subsequently dismissed review as improvidently granted. *Banaitis* v. *Mitsubishi Bank, Ltd.*, 900 P.2d 508 (Or. 1995). See Pet. App. 5a-6a.

Shortly thereafter, the parties entered into a confidential settlement agreement. Pursuant to the settlement agreement, Mitsubishi Bank and the Bank of California issued checks that together totaled $8,728,559: the Bank of California paid $3,864,012 directly to respondent's attorneys and Mitsubishi Bank paid the remaining $4,864,547 directly to respondent. Pet. App. 6a.

5. On his 1995 income tax return, respondent did not include in his gross income any part of the $3,864,012 settlement proceeds paid to his attorneys. The Commissioner determined that $8,103,559 of the settlement proceeds constituted gross income to respondent under Section 61(a) of the Internal Revenue Code, 26 U.S.C. 61(a). The Commissioner further determined that the amount paid to his attorneys pursuant to the contingent fee agreement was a deductible expense, but that such deductions are given no consideration in computing the AMT. The Commissioner accordingly determined a deficiency of $288,798 in respondent's AMT liability. Pet. App. 7a.

Respondent sought review of the Commissioner's determination in the Tax Court. The Tax Court agreed with the Commissioner that respondent was required to include in his gross income the entire settlement relating to economic damages and punitive damages, including the portion paid to his attorneys as a contingent fee. The court therefore sustained the Commissioner's determination of respondent's AMT liability. Pet. App. 8a, 18a-33a.

6. The court of appeals agreed with the Tax Court that "the portions of the settlement representing economic and punitive damages were to be included in the taxpayer's gross income" and rejected respondent's claim that they fell within the exclusion from income for "damages * * * received * * * on account of personal physical injuries" (26 U.S.C. 104(a)(2)). Pet. App. 8a. The court further held, however, that "[t]he Tax Court erred in holding that the attorneys fees paid to [the attorneys] should be included in [respondent's] gross income total." *Id.* at 12a.

On the attorney's fee issue, the court noted that it had held in *Coady* v. *Commissioner*, 213 F.3d 1187, 1190 (9th Cir. 2000), cert. denied, 532 U.S. 972 (2001), and in *Benci-Woodward*, 219 F.3d at 943, that the portion of damages paid as attorney's fees under contingent fee agreements made in Alaska and California,

respectively, *must* be included in the taxpayers' gross incomes, because Alaska and California law did not provide the attorney with an ownership interest in the litigant's cause of action or with any right or power over the suit. See Pet. App. 12a-13a. In those decisions, the Ninth Circuit had distinguished cases in other circuits that had reached the opposite conclusion. See *Coady*, 213 F.3d at 1190 (distinguishing, *inter alia*, *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959), which held that, under Alabama law, attorney acquired ownership of a portion of client's cause of action and therefore attorney's fees portion of award was excludable from gross income).

In this case, however, the Ninth Circuit held that, under Oregon law, the portion of respondent's recovery that was paid to his attorneys pursuant to the contingent fee agreement was not includable in his gross income. The court distinguished its prior decisions in *Coady* and *Benci-Woodward* by stating that Oregon law with respect to contingent attorney's fees "is unlike the laws of California and Alaska." Pet. App. 15a. The court opined that the statutory lien for attorney's fees under Oregon law "mirrors Alabama law [at issue in *Cotnam* v. *Commissioner*, *supra*] in that it affords attorneys generous property interests in judgments and settlements." *Ibid.* The court stated (*ibid.*) that "[u]nlike California and Alaska law, an attorney's lien in Oregon is 'superior to all other liens' except 'tax liens.' O.R.S. § 87.490." It further noted (Pet. App. 15a-16a) that "Oregon law, like Alabama law, provides that attorneys shall have 'the same right and power over actions, suits, proceedings, judgments, decrees, orders and awards to enforce their liens as their clients have for the amount of judgment due thereon to them.' O.R.S. § 87.480." In fact, the court asserted, "Oregon goes even further than does the Alabama law at issue in *Cotnam*," by "recogniz[ing] that an attorney has a right to sue a third party for attorneys fees that were left unsatisfied by a private settlement with the attorney's clients." Pet. App. 16a (citing *Potter* v. *Schlesser Co.*, 63 P.3d 1172, 1174 (Or. 2003)). Thus, the court concluded, "[b]ecause of the unique features of Oregon law," the contingent attorney's fees portion of respondent's settlement proceeds was not to be included in his gross income for federal income tax purposes. *Ibid.*

SUMMARY OF ARGUMENT

1. As a matter of federal law, the contingent-fee portions of the proceeds from respondents' suits are includable in their gross income. It is a fundamental rule of taxation that income is to be taxed to the person who earns it, even when it is paid at that person's direction to someone else. *Lucas* v. *Earl*, 281 U.S. 111, 114-115 (1930). It is similarly well settled that, when a debt owed by a taxpayer is satisfied by a direct payment from a third party to the taxpayer's creditor, the taxpayer receives "income" in the amount of the discharged debt. *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 729 (1929). Thus, as the Court explained in *Helvering* v. *Horst*, 311 U.S. 112, 116-117 (1940), "he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants." Accordingly, where a taxpayer assigns to another "an obligation to pay compensation" to the taxpayer, he has "divert[ed] the payment from himself to others as the means of procuring the satisfaction of his wants" and is subject to tax on the diverted proceeds. *Id.* at 117, 118.

Here, respondents had the sole power to assert and to settle their claims; their claims sought recoveries in the form of taxable income; and the settlement proceeds represent the value given in exchange for the dismissal of respondents' claims. Respondents therefore controlled—and, indeed, were—"the source of the income" at issue, and they "divert[ed] the payment [of a portion of that income] from [themselves] to others as the means of procuring the satisfaction of [their] wants." *Horst*, 311 U.S. at 116-117. Accordingly, whatever the precise nature and scope of the right obtained by an attorney pursuant to a contingent fee agreement, the proceeds from respondents' litigation awards are "recover[ies] of lost income; the attorney fees [they] paid represent expenses incurred in generating that income"; and "[l]ike any other taxpayer, [respondents] must report the entire amount as gross income." *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d 1312, 1314 (10th Cir. 2001), cert. denied, 535 U.S. 1056 (2002).

2. The Sixth Circuit below attempted to distinguish those fundamental principles of federal tax law, but its efforts are unavailing. As this Court's decision in *Lucas* v. *Earl*, *supra*, makes clear, the fact that respondents had only an "intangible contingent expectancy" at the time they entered into their contingent fee agreements provides no justification for deviating from those principles, because *Earl* itself involved an intangible, contingent interest.

Equally misguided is the Sixth Circuit's suggestion (03-892 Pet. App. 24a-25a) that a contingent fee agreement operates "like a partnership or joint venture" and "transfer[s] some of the trees from the [plaintiff's] orchard [to the attorney], rather than simply transferring some of the orchard's fruit." As the agreements in these cases demonstrate, a contingent fee agreement is

merely a promise by the client to pay his attorney a portion of the proceeds of the litigation as compensation for services rendered; the relationship between the client and his attorney is simply that of debtor and creditor. Even if the contingent fee agreement could be characterized as effecting an assignment to the attorney, moreover, at most it would be an assignment of "an obligation [on the part of the defendant] to pay compensation" to the plaintiff, *Horst*, 311 U.S. at 117, and thus would not reduce the gross income of the assignor. And even if the contingent fee agreement could be viewed as assigning an ownership interest in an income-producing asset to the attorney—which it plainly cannot—the same result would obtain. Respondents at all times exercised sufficient power and control over both the underlying causes of action and the receipt of the income to make it reasonable to treat the entire awards as gross income.

3. Even if this Court were to follow the approach of some courts of appeals and look to state law to determine the tax treatment of the contingent-fee portion of the litigation proceeds in these cases, reversal would still be required. California law is clear that the relationship between respondent Banks and his attorney was simply that of debtor and creditor, rather than partners or co-proprietors. Therefore, the entire amount of respondent Banks's litigation award must be included in his gross income.

Similarly, Oregon law does not confer on the attorney any ownership interest in his client's cause of action or otherwise give the attorney control over the action. Rather, it defines the attorney's interest in his fees as nothing more than that of a lienholder, not that of a part-owner or co-venturer. The concepts of lienholder and property owner necessarily are mutually exclusive,

because a property owner cannot have a lien on his own property. Thus, even taking into account Oregon's laws protecting an attorney's interest in his fees, it is clear that respondent Banaitis retained sufficient control over the amount and timing of the contingent fee to require inclusion of the entire taxable portion of his litigation award in his gross income.

ARGUMENT

I. AS A MATTER OF FEDERAL LAW, THE CONTINGENT-FEE PORTION OF A DAMAGES RECOVERY IS INCLUDED IN THE LITIGANT'S TAXABLE INCOME UNDER SECTION 61(a) OF THE INTERNAL REVENUE CODE

Fundamental, long-standing principles of federal tax law compel the conclusion that litigation proceeds do not lose their status as income to the successful litigant merely because they are paid as fees to the litigant's attorney. The tax treatment of contingent fees is a question of federal law, because, although state law is relevant to defining the taxpayer's interest in property, "the tax consequences [of the receipt or disposition of property] are dictated by federal law." *United States* v. *National Bank of Commerce*, 472 U.S. 713, 722 (1985). Federal tax law makes clear that income is taxed to the person who earned it—here, the plaintiff whose lawsuit is predicated on his right to recover lost wages or other taxable income to which he is entitled by law—regardless of any arrangements made by the taxpayer transferring the right to receive that income to a third party. Accordingly, the courts below erred in excluding from gross income the portions of the litigants' recoveries that were paid to their attorneys.

A. The Tax Treatment Of The Contingent-Fee Portion Of A Damages Recovery Is A Question Of Federal, Not State, Law

The determination whether an amount is includable in gross income is governed by Section 61(a) of the Internal Revenue Code (26 U.S.C. 61(a)), which provides that "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived." That statutory definition of gross income is "sweeping" in its scope, reflecting Congress's intent to exert "the full measure of its taxing power." *Commissioner* v. *Schleier*, 515 U.S. 323, 327-328 (1995); *Helvering* v. *Clifford*, 309 U.S. 331, 333 (1940). This Court has therefore given a "liberal construction" to this "broad" definition of gross income "in recognition of the intention of Congress to tax *all* gains except those specifically exempted." *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 430 (1955) (emphasis added).[3]

Section 61(a), like the Internal Revenue Code more generally, "creates no property rights but merely attaches consequences, federally defined, to rights created under state law." *National Bank of Commerce*, 472 U.S. at 722 (quoting *United States* v. *Bess*, 357 U.S. 51, 55 (1958)). Accordingly, although state law determines the nature of legal interests in property, federal law determines the tax consequences of the receipt or disposition of property. See *ibid.*; *Aquilino* v. *United*

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[3] Recoveries for "personal physical injuries or physical sickness" are excluded from gross income. 26 U.S.C. 104(a)(2). Where that exclusion applies, of course, the issue presented here does not arise. Both courts of appeals held that respondents' recoveries do not fall within that exclusion. 03-892 Pet. App. 8a-17a; 03-907 Pet. App. 8a. Respondents did not petition this Court to review that issue, nor did they raise it in their briefs in opposition, and accordingly it is not before the Court. See Sup. Ct. R. 15.2.

States, 363 U.S. 509, 513-514 (1960). As this Court has explained, "'[o]nce it has been determined that state law creates sufficient interests in the [taxpayer] to satisfy the requirements of [the federal revenue statute], state law is inoperative,' and the tax consequences thenceforth are dictated by federal law." *National Bank of Commerce*, 472 U.S. at 722 (citation omitted).

There is no doubt that, under any view of state law, respondents were the sole plaintiffs in their causes of action and would have been required to include the entire taxable proceeds from those causes of action in their gross income if the proceeds had been paid directly to them. Indeed, by their nature, the basis of respondents' claims was the recovery of lost income. It necessarily follows, therefore, that the recoveries based on those claims represented income to respondents. As this Court explained in *Commissioner* v. *Sunnen*, 333 U.S. 591, 604 (1948), "[a]s long as the assignor actually earns the income or is otherwise the source of the right to receive and enjoy the income, he remains taxable."

The only remaining question is whether a plaintiff can reduce his gross income by arranging to have a portion of those proceeds paid directly to his attorney pursuant to a contingent fee contract. As the Second, Fourth, Seventh, and Tenth Circuits have correctly concluded, the question of the tax treatment of the contingent-fee portion of a damages recovery is fundamentally a matter of federal, not state, law. See *Raymond* v. *United States*, 355 F.3d 107 (2d Cir. 2004), petition for cert. pending, No. 03-1415 (filed Apr. 9, 2004); *Young* v. *Commissioner*, 240 F.3d 369 (4th Cir. 2001); *Kenseth* v. *Commissioner*, 259 F.3d 881 (7th Cir. 2001); *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d 1312

(10th Cir. 2001), cert. denied, 535 U.S. 1056 (2002).[4] The Fourth Circuit in *Young*, for example, explained that "whether amounts paid directly to attorneys under a contingent fee agreement should be included within the client's gross income should be resolved by proper application of federal income tax law, not the amount of control state law grants to an attorney over the client's cause of action." 240 F.3d at 378.

Similarly, the Fifth Circuit in *Srivastava* v. *Commissioner*, 220 F.3d 353 (2000), emphasized that the fact that one State may "give[] its contingent fee *attorneys*

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[4] The First and Third Circuits also appear to have adopted the view that federal, not state, law governs the tax treatment of the contingent-fee portion of the proceeds of a lawsuit. Thus, in *Alexander* v. *IRS*, 72 F.3d 938, 944-946 (1995), the First Circuit held that the contingent-fee portion of a taxable damages recovery was includable in the taxpayer's gross income under federal tax law principles without any reference to state law.

The Third Circuit, in *O'Brien* v. *Commissioner*, 319 F.2d 532, cert. denied, 375 U.S. 931 (1963), affirmed the decision of the Tax Court, 38 T.C. 707 (1962), which, among other things, had held that the tax treatment of the contingent-fee portion of a litigation award for back pay was a question of federal law. After noting that "there is room for argument * * * under Pennsylvania law" about the attorney's interests in the recovery and the underlying suit, the Tax Court concluded: "[I]t [is] doubtful that the Internal Revenue Code was intended to turn upon such refinements. For, even if the taxpayer had made an irrevocable assignment of a portion of his future recovery to his attorney to such an extent that he never thereafter became entitled thereto even for a split second, it would still be gross income to him under the familiar principles of *Lucas* v. *Earl*, 211 U.S. 111, *Helvering* v. *Horst*, 311 U.S. 112, and *Helvering* v. *Eubank*, 311 U.S. 122." *O'Brien*, 38 T.C. at 712. In its per curiam order, the court of appeals stated that "the decision of the Tax Court is correct in all respects," and it therefore "affirmed [based] on the excellent opinion of" the Tax Court. 319 F.2d at 532.

a greater degree of power to enforce their rights than does" another "should not affect the analysis required by the [federal] anticipatory assignment of income doctrine, which looks to the *taxpayer's* degree of control and dominion over the asset." *Id.* at 363-364 (emphases added). Thus, although the Fifth Circuit in *Srivastava* recognized that it could not decide that case "on a clean slate," but instead was required to "follow the contrary approach [it] endorsed in *Cotnam*," it went out of its way to note that "were we to decide this case as an original matter, we might apply the [federal] anticipatory assignment doctrine to hold that contingent fees are gross income to the client." *Id.* at 363.

Even the Sixth Circuit below correctly concluded that the proper tax treatment of contingent fee proceeds "does not depend on the intricacies of an attorney's bundle of rights against the opposing party under the law of the governing state." 03-892 Pet. App. 23a-24a (citation omitted). But unlike each of the circuits discussed above, the Sixth Circuit held that as a matter of federal law such proceeds are never includable in the litigant's gross income. *Id.* at 25a. That approach is plainly mistaken.

B. This Court's Decisions Require That Income Be Taxed To The Person Who Earned It, Notwithstanding Any Attempt To Transfer The Right To Receive Such Income To Another

1. The Assignment-Of-Income Doctrine Ensures Taxation Of Income To The Person Who Earns It Or Is The Source Of The Right To Receive And Enjoy It

It is axiomatic that income is to be taxed to the person who earns it, even when it is paid at that person's direction to someone else. *Lucas* v. *Earl*, 281 U.S.

111, 114-115 (1930); *Helvering* v. *Horst*, 311 U.S. 112, 115-116 (1940). For example, in *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716 (1929), the taxpayer's employer paid all the income taxes on the taxpayer's salary directly to the Government, and the taxpayer excluded the payment from his gross income on the ground that the payment was not made to him. The Court held that, because the payment was made in consideration of services rendered by the taxpayer, the payment was includable in the taxpayer's gross income, notwithstanding that it had been made by the taxpayer's employer directly to the Government. The Court explained that "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." *Id.* at 729.

In *Lucas* v. *Earl*, *supra*, this Court established that a taxpayer cannot avoid the rule that income is taxed to the person who earns it by making an anticipatory assignment of income, even where the taxpayer assigns income that he has not yet earned the right to receive. In *Earl*, a husband and wife contracted in 1901 that they would hold all of their future income as joint tenants. Based on that contract, the husband reported on his tax returns only one-half of the income he had earned in 1920 and 1921. The Court held that, notwithstanding the husband's anticipatory assignment of his income, he was required to include in his gross income the entire amount of his earnings during the years at issue. Writing for the Court, Justice Holmes explained that the "import" of the income tax statutes was to "tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." 281 U.S. at 114-115.

The assignment-of-income doctrine is a practical necessity in a system of graduated taxation; without it, a taxpayer in a high tax bracket could avoid heightened levels of taxation simply by shifting income to a lower-bracket taxpayer. This apparently was not the intention of the husband and wife in *Earl* (their 1901 assignment predated the income tax), but the Court declined to give weight to "the motives leading to the arrangement," 281 U.S. at 115, presumably because such a "motives" test would be judicially intractable and subject to abuse. See *Raymond*, 355 F.3d at 112.

This Court reaffirmed and further explained the assignment-of-income doctrine in *Helvering* v. *Horst*, *supra*, where the taxpayer made a gift of bond coupons (reflecting the right to receive interest payments) to his son, while retaining the bonds for himself. The son redeemed the coupons in the same year, receiving in return the interest payments due. The taxpayer excluded from his gross income the coupon redemption proceeds paid to his son. 311 U.S. at 114. The Court held that, notwithstanding the fact that the redemption proceeds were paid to the son, the taxpayer was obligated to include them in his gross income. *Id.* at 120. Writing for the Court, Justice Stone explained that "[t]he power to dispose of income is the equivalent of ownership of it." *Id.* at 118. Because the taxpayer had retained control of the bonds, he retained control of the source of the income, and in those circumstances a taxpayer "has equally enjoyed the fruits of his labor or investment and obtained the satisfaction of his desires whether he collects and uses the income to procure those satisfactions, or whether he disposes of his right to collect it as the means of procuring them." *Id.* at 117.

In so holding, the Court in *Horst* distinguished between the assignment of "income-producing property"

and the assignment of income derived from "an obligation to pay compensation" to the taxpayer. *Horst*, 311 U.S. at 118. When a taxpayer assigns all of his rights to income-producing property, he is not properly treated as the recipient of income subsequently derived from the property; in such a case, the taxpayer has wholly relinquished control over the disposition of the future income. But when he assigns the right to receive income derived from an obligation to pay compensation *to him*, he is properly treated as the recipient of the income despite having "shifted" it to another.

The Court in *Horst* also emphasized that the "realization" of income—*i.e.*, the "gain" derived from control of income-producing property or from an obligation to pay compensation—can take many forms. The key is that through controlling the disposition of income, the taxpayer has received the benefit thereof, and is accordingly subject to tax. Referring to the taxpayer's gift of interest coupons in *Horst*, the Court explained that when a taxpayer uses his "right to receive income[] to procure a satisfaction which can be obtained only by the expenditure of money or property," he has "enjoy[ed] * * * the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such non-material satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son." 311 U.S. at 117. That is true, moreover, even though the taxpayer "never receives the money," because "he derives money's worth from the disposition of the [income] which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth." *Ibid.* The taxpayer in *Horst* enjoyed "the economic benefit" from his right to receive income from the

coupons "as completely as * * * if he had collected the interest in dollars and expended them for any of the purposes named." *Ibid.*

Thus, where a taxpayer assigns income-producing property to another, thereby relinquishing all control over it, that taxpayer gives up the power to use that property in such a way as to realize a gain. But where a taxpayer retains control over an income-producing asset, that taxpayer has the power to gain through the satisfaction of assigning its income to whomever he pleases. Such a gain is gross income. *Horst*, 311 U.S. at 117; see *Sunnen*, 333 U.S. at 610 (assignments of license contracts merely involved a transfer of the right to receive income rather than a complete disposition of all the taxpayer's interest in the contracts and royalties from the contracts; "[t]he existence of the taxpayer's power to terminate those contracts and to regulate the amount of the royalties rendered ineffective for tax purposes his attempt to dispose of the contracts and royalties"). Likewise, where a taxpayer assigns to another "an obligation to pay compensation" to the taxpayer, *Horst*, 311 U.S. at 118, the taxpayer has "divert[ed] the payment from himself to others as the means of procuring the satisfaction of his wants" and is therefore subject to tax on the diverted proceeds, *id.* at 117.

2. As Most Courts Of Appeals To Consider The Question Have Held, All Taxable Litigation Proceeds Must Be Included In The Plaintiff's Gross Income

The majority of the courts of appeals that have addressed the question have correctly held that the fundamental tax principles discussed above mandate the inclusion of the entire amount of a taxable damages recovery, including the portion of the recovery paid to

the plaintiff's attorney pursuant to a contingent fee agreement, in the plaintiff's gross income under Section 61 of the Internal Revenue Code. *Raymond*, 355 F.3d at 112 (Second Circuit); *Hukkanen-Campbell*, 274 F.3d at 1314 (Tenth Circuit); *Kenseth*, 259 F.3d at 883 (Seventh Circuit); *Young*, 240 F.3d at 378 (Fourth Circuit); *Baylin* v. *United States*, 43 F.3d 1451 (Fed Cir. 1995); *O'Brien* v. *Commissioner*, 319 F.2d 532 (3d Cir. 1963), aff'g 38 T.C. 707 (1962), cert. denied, 375 U.S. 931 (1963). See also *Coady* v. *Commissioner*, 213 F.3d 1187 (9th Cir. 2000), cert. denied, 532 U.S. 972 (2001); *Benci-Woodward* v. *Commissioner*, 219 F.3d 941 (9th Cir. 2000), cert. denied, 531 U.S. 1112 (2001). But see *Davis* v. *Commissioner*, 210 F.3d 1346 (11th Cir. 2000); *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2000); *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959).

As the Second Circuit explained in *Raymond*, "[t]he analysis of whether something is 'gross income' begins with whether it can reasonably be considered a 'gain' to the taxpayer under 26 U.S.C. 61(a)." 355 F.3d at 115 (citing *Glenshaw Glass*, 348 U.S. at 429-430). The fact that the taxpayer, in light of his assignment, never actually receives the funds, or even that he has no right to receive them in light of a lien placed on them under state law, does not preclude those funds from being considered a gain to the taxpayer and therefore part of his gross income. As this Court's decision in *Horst* makes clear, "a taxpayer can realize a gain subject to taxation where, although he 'never receives the money, he derives money's worth from the disposition of [the source of the income] which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth.'" *Ibid.* (quoting *Horst*, 311 U.S. at 117). Respondents "control[led] the source of the income

[and] * * * divert[ed] the payment from [themselves] to others as the means of procuring the satisfaction of [their] wants." *Horst*, 311 U.S. at 116-117. Specifically, they diverted a portion of their recovery of income to their attorneys in the furtherance of receiving the remainder of that recovery for themselves, which was "certainly a result 'procurable only by the expenditure of money or money's worth.'" *Raymond*, 355 F.3d at 115 (quoting *Horst*, 311 U.S. at 117).

Whatever the precise nature and scope of the right obtained by an attorney pursuant to a contingent fee agreement, it remains true that the plaintiff's right to a recovery from the defendant is, by definition, a claim for a recovery that would unquestionably be includable in gross income if paid to the plaintiff.[5] As the Tenth Circuit explained in *Hukkanen-Campbell*, 274 F.3d at 1314, "irrespective of a particular state's attorney lien statute's provisions," the proceeds from respondents' litigation awards are "recover[ies] of lost income; the attorney fees [they] paid represent expenses incurred in generating that income." Accordingly, "[l]ike any other taxpayer, [respondents] must report the entire amount as gross income, and, but for the AMT's provisions, [they] would be allowed to deduct [their] attorney fees as an expense." *Ibid.*; *Helvering* v. *Eubank*, 311 U.S. 122 (1940).

As Judge Posner explained for the Seventh Circuit in *Kenseth* v. *Commissioner*, 259 F.3d at 883, moreover, the fact that respondents elected to pay their attorneys

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[5] Not every type of litigation recovery constitutes gross income to the plaintiff within the meaning of the Internal Revenue Code. The question presented in these cases, accordingly, arises only in cases, like those at issue here, in which the plaintiff is seeking a recovery that would qualify as gross income in one form or another.

a contingent rather than a fixed fee provides no basis for excluding those fees from respondents' gross income. Rather, like the taxpayer in *Kenseth*, respondents "concede[] * * * that had [they] paid the law firm[s] on an hourly basis, the fee would have been an expense. It would have been a deduction from, not a reduction of, [their] gross income." *Ibid.* With respect to their tax liabilities, it makes no difference "that the expense happened to be contingent rather than fixed." *Ibid.*

In sum, it is undisputed that respondents had the sole power to assert and settle their causes of action; that the sums they claimed fell within the category of taxable income; and that the settlement proceeds represented the value given in exchange for the dismissal of their claims. The entire taxable amount of those proceeds is therefore income to respondents, subject to whatever deductions are allowable under the Code. *Hukkanen-Campbell*, 274 F.3d at 1313-1314; *Kenseth*, 259 F.3d at 884-885; *Young*, 240 F.3d at 378; *Raymond*, 355 F.3d at 115. That Congress has not seen fit to allow any deduction for attorney's fees for purposes of the AMT provides no basis to create the fiction, as did the courts of appeals below, that the gross income received by a plaintiff from the successful prosecution of a cause of action includes only the net amount recovered after payment of the plaintiff's attorney's fees. *Raymond*, 355 F.3d at 115; *Kenseth*, 259 F.3d at 883; *Hukkanen-Campbell*, 274 F.3d at 1314; see *Alexander* v. *IRS*, 72 F.3d 938, 944-946 (1st Cir. 1995).

C. Respondents' Attempts To Distinguish The Tax Principles Established By *Old Colony*, *Earl*, And *Horst* Are Unavailing

In reaching its erroneous conclusion that the portion of respondent Banks's damages recovery paid at his direction to his attorney is not part of his gross income, the Sixth Circuit did not attempt to refute the settled law in California (where Banks's contingent fee agreement was executed) that the attorney acquired only a lien, and not a proprietary interest, in the cause of action under the contingent fee agreement. See *Benci-Woodward*, 219 F.3d at 943; see also *Isrin* v. *Superior Court of Los Angeles County*, 403 P.2d 728 (Cal. 1965); *Cooper* v. *Equity Gen. Ins.*, 268 Cal.Rptr. 692, 696 (Ct. App. 1990) ("[a] contingent fee contract does not transfer to the attorney any rights to the client's cause of action, but rather gives the attorney a lien on the client's prospective recovery"). Instead, the Sixth Circuit, alone among all of the courts of appeals that have addressed the question, held that gross income as defined in Section 61(a) *never* includes the portion of a taxable damages recovery that is paid to the plaintiff's attorney under a contingent fee agreement.

The Sixth Circuit concluded that its across-the-board exclusion for the portions of damages awards paid to plaintiffs' attorneys under contingent fee agreements was not precluded by the decisions of this Court in *Old Colony*, *Earl*, and *Horst* and was justified by the following factors: (1) the plaintiff's claim, at the time the contingent fee agreement is signed, is "an intangible, contingent expectancy"; (2) the plaintiff's claim is "like a partnership or joint venture" in which the plaintiff assigns away part of his claim in hope of recovering the remaining portion; (3) no "tax-avoidance purpose" is

at work in a contingent fee arrangement; and (4) "double taxation would otherwise result by including the contingency fee in taxpayer's income." 03-892 Pet. App. 24a (citation omitted); see 03-892 Br. in Opp. 3-4, 6-8 (repeating Sixth Circuit's arguments). None of those four factors, however, which the court derived from its earlier decision in *Estate of Clarks*, provides any justification for the Sixth Circuit's refusal to follow the fundamental rule of taxation that income is taxed to the person who earns it, even when it is paid at that person's direction to someone else.

1. The Contingent Nature Of The Fee Provides No Basis For An Exclusion From Gross Income

Contrary to the Sixth Circuit's conclusion, it is of no moment that, at the time a contingent fee agreement is executed, the client has no right to receive any income, but instead has only an unproven claim that he is entitled to income. *Earl* itself concerned an uncertain, future right to receive income. There, the husband and wife agreed to co-own any future income each might earn. At the time of the agreement, the amount of future income, if any, was necessarily uncertain. The question before this Court in *Earl* therefore was whether an *anticipatory* assignment of income, *i.e.*, an assignment made of contingent *future* income that had not yet been earned or even ascertained by the taxpayer-assignor, would be effective to shift the incidence of tax away from the taxpayer on subsequently earned income that was paid directly to the taxpayer's assignee. The Court answered that question in the negative. As the Second Circuit concluded in *Raymond*, "[i]n both this case and *Earl*, the taxpayers assigned the right to receive a portion of as yet unascertained income to another. And in both cases, the

assignment was 'ineffective to shift . . . tax liability.'" 355 F.3d at 117 (citation omitted); see *Baylin*, 43 F.3d at 1455 ("That the partnership assigned a portion of its * * * recovery to its attorney before it knew the exact amount of the recovery does not mean that this amount never belonged to the partnership; it means simply that the attorney and client chose to estimate the value of the attorney's services by tying the fee to the ultimate recovery * * *. The temporarily uncertain magnitude of the legal fees under such an arrangement and the vehicle of an assignment cannot dictate the income tax treatment of those fees.").

Similarly, this Court applied the assignment-of-income doctrine in *Commissioner* v. *Sunnen*, 333 U.S. at 594, 603-610, to an assignment of royalty contracts that provided for a royalty of 10% of gross sales of certain devices, even though the agreements did not require the manufacture or sale of any particular number of devices and did not specify a minimum amount of royalties. Indeed, the fact that the amount of royalties was uncertain and would turn, in large part, on the actions of the assignor was a significant factor in support of the Court's conclusion that the assignor retained sufficient control over the income that the funds should be included in his gross income. The same is true here: although the amount of the recovery, and hence the contingent fee, was uncertain at the time the fee agreement was executed, respondents, by retaining the ultimate authority to decide whether and when to settle and for how much, enjoyed substantial control over the amount and timing of the contingent fee. Thus, even assuming *arguendo* that a contingent fee agreement could be considered to be an assignment of a portion of the income that the client expects to realize in the future, *Earl* is controlling and requires the client to

include in his gross income the entire taxable amount recovered on his cause of action.

2. A Contingent Fee Arrangement Does Not Provide The Attorney An Ownership Interest In His Client's Action Or Otherwise Convert The Attorney-Client Relationship Into A Partnership Or Joint Venture

Equally misconceived is the Sixth Circuit's suggestion (03-392 Pet. App. 24a-25a) that a contingent fee agreement operates "like a partnership or joint venture" and that "[b]y signing the contingency fee agreement * * * [respondent] transferred some of the trees from the orchard, rather than simply transferring some of the orchard's fruit." There is no authority (and none was cited by the Sixth Circuit below) supporting the notion that when respondent signed the contingent fee agreement in California he thereby formed a partnership or joint venture with his attorney, or otherwise transferred to his attorney a proprietary interest in his cause of action.

To the contrary, it is clear that a contingent fee agreement does not even effect an actual assignment of the client's future income to his attorney. See *Kenseth*, 259 F.3d at 884; *Young*, 240 F.3d at 378. Instead, it merely constitutes a promise by the client to pay his attorney a portion of the proceeds of the litigation as compensation for services rendered. *Ibid.* The relationship between the client and his attorney is simply that of debtor and creditor. Although States provide attorneys with a lien on the proceeds of the client's cause of action, the effect of such a lien is merely to make the attorney a secured creditor, rather than a general one. It does not provide the attorney with a proprietary interest in the client's cause of action. See *Young*, 240 F.3d at 378 n.7.

Indeed, the concepts of lienholder and property owner are mutually exclusive, since a property owner obviously cannot have a lien on his own property. See *Black's Law Dictionary* 933 (7th ed. 1999) (defining "lien" as "[a] legal right or interest that a creditor has *in another's property*, lasting usu[ally] until a debt or duty that it secures is satisfied" (emphasis added)). Thus, under the rule set forth in *Old Colony Trust Co.*, it follows that the direct payment to the client's attorney pursuant to a contingent fee agreement of a portion of the client's recovery is the taxable discharge of the debt owed by the client to his attorney. See 279 U.S. at 729 ("The discharge by a third person of an obligation to him is equivalent to receipt by the person taxed."); see also *Hukkanen-Campbell*, 274 F.3d at 1313-1314; *Baylin*, 43 F.3d at 1454.

Moreover, even assuming—contrary to the foregoing principles—that a contingent fee agreement could properly be characterized as "an assignment of a portion of the potential judgment" to the attorney (03-892 Pet. App. 21a), that would not convert the attorney-client relationship into a partnership or provide any other basis for creating an exception to the assignment-of-income doctrine. The "judgment" in this context is nothing more than the plaintiff's judicially determined right to receive income from the defendant. Any assignment of a portion of that right, therefore, is necessarily an assignment *of income* subject to the rule in *Earl* and *Horst*. The fact that the attorney agrees to provide services under the contingent fee agreement in order to enforce the defendant's obligation to pay compensation to the plaintiff is not a legitimate basis on which to distinguish *Earl* and *Horst*. The litigant in a contingent-fee case "controls the source of the income [and] * * * diverts the payment from himself to

others as the means of procuring the satisfaction of his wants." *Horst*, 311 U.S. at 116-117. As the Second Circuit put it in *Raymond*, "[h]e divert[s] a portion of his judgment to his attorney in the service of receiving the remainder of that judgment—certainly a result 'procurable only by the expenditure of money or money's worth.'" 355 F.3d at 115 (quoting *Horst*, 311 U.S. at 117).

Nor does the fact that the attorney must perform services in order to generate any recovery of income on the taxpayer's cause of action justify treating contingent fees differently from fixed attorney's fees. The attorney's efforts are equally necessary to the realization of income regardless of whether he is paid a fixed or contingent fee. As the Seventh Circuit noted in *Kenseth*, a litigant "no more relinquishe[s] control of the claim to his contingent-fee lawyer than he [does] to a fixed-fee lawyer. He could fire either one and would owe either one for work done but not paid for." 259 F.3d at 884.

In any event, even if a contingent fee agreement could be viewed as an "assignment" of "income-producing property" within the meaning of *Horst*—which it plainly cannot—the result would be the same. As this Court explained in a somewhat analogous context in *Commissioner* v. *Sunnen*, 333 U.S. at 604-605, "[t]he crucial question" in applying the assignment-of-income doctrine to a purported assignment of income-producing property is not "trac[ing] income to the property which is its true source" or identifying what property, if any, "has [truly] been assigned." Rather, the key question in that context "remains whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income

for tax purposes." *Ibid.* As the Court observed in *Corliss* v. *Bowers*, 281 U.S. 376, 378 (1930), quoted in *Sunnen*, 333 U.S. at 604, "taxation is not so much concerned with the refinements of title as it is with actual command over the property taxed—the actual benefit for which the tax is paid."

Here, it is clear that respondents and their causes of action were at all times "the source of the right to receive and enjoy the income." *Sunnen*, 333 U.S. at 604. Regardless of how one characterizes the contingent fee agreement or the rights of the attorney to collect his fee, moreover, it is clear that respondents at all times exercised "sufficient power and control" over both the underlying cause of action and the receipt of the income to make it reasonable to treat them as the recipients of the entire award of income for tax purposes. Among other things, respondents "could have fired [their] attorney[s]. [They] could have dropped the case[s]. [They], and only [they], had the power to authorize a settlement of the claim[s]." *Raymond*, 355 F.3d at 116.

In addition, any right or interest the attorneys received under the contingent fee agreements was necessarily limited by their overriding fiduciary duty to respondents to act only in the best interests of respondents in prosecuting respondents' claims. At a minimum, therefore, these cases fit squarely within this Court's "recogni[tion] that the assignor may realize income if he controls the disposition of that which he could have received himself and diverts payment from himself to the assignee as a means of procuring the satisfaction of his wants, the receipt of income by the assignee merely being the fruition of the assignor's economic gain." *Sunnen*, 333 U.S. at 605-606. Respondents' income was "realized as completely as it would

have been if [they] had collected the [awards] in dollars" and then paid their attorneys. *Horst*, 311 U.S. at 117.

3. A Taxpayer's Motive In Entering A Contingent Fee Agreement Is Irrelevant For Tax Purposes

Nor do the tax consequences of a contingent fee agreement turn in any way on whether tax avoidance was the motive for the agreement. This Court in *Earl* expressly held that "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew." 281 U.S. at 115. The anticipatory assignment of income between the husband and wife in *Earl* was made in 1901, well before the advent of the individual income tax, and thus evidently was not motivated by tax avoidance. Nevertheless, the Court refused to give any weight to that fact. *Ibid.*

The Sixth Circuit's attempt to resurrect a "purpose" inquiry in this context is contrary to *Earl* and should be rejected; "to rest the applicability of a rule of law on ascertaining the 'motives' of the parties is to court procedural unmanageability." *Raymond*, 355 F.3d at 117. Such an approach would put courts "in the position of having to divine the unknowable—and would open the door to abuse," *ibid.*, by "creat[ing] an artificial, a purely tax-motivated, incentive to substitute contingent for hourly legal fees," *Kenseth*, 259 F.3d at 884. Accordingly, respondents' motives for entering into a contingent fee arrangement with their attorneys are irrelevant to the tax treatment of the proceeds of their lawsuits. If a portion of a wage earner's income is paid directly by his employer to the wage earner's creditor pursuant to a garnishment, the direct payment is obviously not motivated by a tax avoidance purpose, yet it would be absurd to contend that the garnished amount

should be excluded from the wage earner's gross income. See *Old Colony Trust Co.*, 279 U.S. at 729. Respondents' situation is no different.

4. The Court Of Appeal's Concern About "Double Taxation" is Entirely Misplaced

The Sixth Circuit's final basis for distinguishing the assignment-of-income doctrine—the court's objection to what it characterized as "double taxation"—similarly provides no basis for the result reached below. Respondents, of course, have not been subjected to double taxation on the same item of income. The court's reference to "double taxation" apparently refers to the fact that, because respondents' attorney's fees are not deductible for purposes of the AMT, the amounts paid as attorney's fees will be taxed both to respondents and to their attorneys. This purported "double taxation," however, is neither anomalous nor harsh, but is instead a commonplace result inherent in the very nature of an income tax. Whenever an individual uses taxable income to purchase goods or services for which the Internal Revenue Code does not allow a deduction, that amount is taxed both to the individual purchaser and to the provider of the goods or services.

Thus. when an individual uses a portion of his salary to pay for the services of a plumber, the same income is taxed to both the individual and the plumber. And, of course, when an individual uses his salary income to pay for legal services rendered on an hourly-fee basis, the same income is taxed to both the individual and the attorney. In short, respondents' damages recoveries "replaced lost income, which would have been taxable; and many of the expenses of producing that income, such as the cost of commuting, would not have been deductible. So incomplete deductibility here is not surprising or anomalous or inappropriate." *Kenseth*, 259 F.3d at 884. That is particularly true in the context of the AMT, the purpose of which is "to limit otherwise allowable deductions, so that * * * everybody who has income pays some federal income tax." *Ibid.*

There is no dispute that if respondents had arranged to pay their attorneys a fixed, rather than a contingent, fee, respondents would have been required to include the entirety of their taxable litigation awards in their gross income. There is no reason why the result should be any different when payment to the attorney is made pursuant to a contingent fee agreement. *Kenseth*, 259 F.3d at 883. That is particularly true given that under both California and Oregon law an hourly fee arrangement gives rise to precisely the same type of attorney lien as a contingent fee arrangement. See Or. Rev. Stat. § 87.445 (2004); *Isrin*, 403 P.2d at 732.

II. EVEN IF THE COURT WERE TO LOOK TO THE MEANING OF STATE LAW TO DEFINE A TAXPAYER'S GROSS INCOME, THE DECISIONS BELOW SHOULD STILL BE REVERSED

As explained above, some courts, most notably the Fifth, Ninth, and Eleventh Circuits, have relied primarily on the varying provisions of state law in determining whether the contingent-fee portion of taxable litigation proceeds should be included in the litigant's gross income. That approach is mistaken for the reasons explained in Part I.A. above. In any event, however, if this Court were to look to California and Oregon law to determine the tax treatment of the contingent-fee portions of the litigation proceeds in these cases, it should nevertheless hold that those proceeds are includable in gross income.

A. California Law Confirms That The Entire Amount Of Respondent Banks's Litigation Proceeds Should Be Included In His Gross Income

It is clear in *Banks* that if the proper tax treatment of contingent fee proceeds turns on the content of state law, then the Sixth Circuit's decision below was wrong and the entire amount of respondent Banks's litigation proceeds must be included in his gross income. That is precisely the conclusion reached by the Ninth Circuit in *Benci-Woodward*, *supra*, which considered the identical issue and held that under California law (where respondent Banks's fee agreement was executed) the attorney lien that arises upon the execution of a contingent fee agreement "does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients." 219 F.3d at 943. The *Benci-Woodward* court therefore concluded that there was no basis upon which the taxpayer in that case could exclude from her gross income the portion of her damages recovery paid to her attorneys pursuant to a contingent fee agreement.

The Sixth Circuit in *Banks* did not take issue with the Ninth Circuit's interpretation of California law. Nor could it have done so in light of the California Supreme Court's decision in *Isrin* v. *Superior Court of Los Angeles County*, *supra*, where the court explained:

> [I]n whatever terms one characterizes an attorney's lien under a contingent fee contract, it is no more than a security interest in the proceeds of the litigation. * * * While there is occasional language in cases in the effect that the attorney also becomes the equitable owner of a share of the client's cause of action, we stated more accurately in *Fifield Manor* v. *Finston* (1960), 54 Cal.2d 632, 641, 7 Cal. Rptr. 377, 383, 354 P.2d 1073, 1079, 78 A.L.R.2d 813, that contingent fee contracts "do not operate to transfer a part of the cause of action to the attorney but only give him a lien upon his client's recovery."

403 P.2d at 732; accord *Cooper*, 268 Cal.Rptr. at 696 ("[a] contingent fee contract does not transfer to the attorney any rights to the client's cause of action, but rather gives the attorney a lien on the client's prospective recovery").

Accordingly, California law confirms that the relationship between respondent Banks and his attorney was simply that of debtor and creditor. They were not partners, and the attorney acquired no proprietary interest in respondent Banks's cause of action by virtue of the contingent fee agreement. *Benci-Woodward*, 219 F.3d at 943. Therefore, even the courts of appeals that look to state law to decide the issue would hold that the entire amount of respondent Banks's litigation award must be included in his gross income.

B. Oregon Law Confirms That The Entire Taxable Amount Of Respondent Banaitis's Litigation Proceeds Should Be Included In His Gross Income

Unlike the Sixth Circuit, the Ninth Circuit in *Banaitis* relied on state law to support its conclusion that the attorney's fees portion of respondent's damages recovery was not includable in his gross income, applying the same analysis as a line of cases from the Fifth and Eleventh Circuits. See *Cotnam*, 263 F.2d at 119; *Davis*, 210 F.3d at 1346; *Foster* v. *United States*, 249 F.3d 1275 (11th Cir. 2001); *Srivastava*, 220 F.3d at 353; see also *Estate of Clarks*, 202 F.3d at 854. The Ninth Circuit erred, however, as did those other courts of appeals, because state law pertaining to contingent

fee agreements provides no basis for the exclusion recognized by those courts.

Specifically, the Ninth Circuit below likened the statutory lien for attorney's fees under Oregon law to Alabama's statutory lien interpreted by the Fifth Circuit in *Cotnam*, stating that "Oregon law mirrors Alabama law in that it affords attorneys generous property interests in judgments and settlements." 03-907 Pet. App. 15a. The court noted, for example, that Oregon law, like Alabama law, provides that "an attorney's lien * * * is 'superior to all other liens'" except "tax liens"; that "a party to the action, suit or proceeding, or any other person, does not have the right to satisfy * * * any judgment, decree, order or award entered in the action * * * until the lien, and claim of the attorney for fees based thereon, is satisfied in full"; and that attorneys have "the same right and power over actions, suits, proceedings, judgments, decrees, orders and awards to enforce their liens as their clients have for the amount of judgment due thereon to them." *Id.* at 15a-16a (quoting Or. Rev. Stat. §§ 87.490, 87.475, 87.480 (2004)). Thus, based on the "unique features of Oregon law" defining the attorney's interest in his fees, the Ninth Circuit concluded that the contingent fee portion of respondent's taxable litigation proceeds should be excluded from the calculation of respondent's gross income. *Id.* at 16a.

Contrary to the Ninth Circuit's conclusion, however, under Oregon law an attorney does *not* acquire a property interest in a client's cause of action upon the execution of a contingent fee agreement. Section 87.445 of the Oregon Revised Statutes, for example, merely confers upon attorneys "a lien upon actions, suits and proceedings after the commencement thereof," and upon "judgments, decrees, orders and awards entered

therein in the client's favor and the proceeds thereof" to the extent of the attorney's agreed-upon fees or, in the absence of an agreement, the reasonable value of services rendered. Or. Rev. Stat. § 87.445 (2004). Moreover, an attorney's lien will "cease to exist" if the attorney does not file a notice of his claim of lien in accordance with Oregon statutes. *Id.* § 87.465.

The Oregon statutes therefore establish that an attorney's interest in his client's cause of action is that of a lienor—a holder of a security interest—not that of a part-owner or co-venturer. See *Stearns* v. *Wollenberg*, 92 P. 1079, 1081 (Or. 1907) (a contingent fee agreement does not act as an assignment in favor of the attorney without express stipulation and does not create any "legal or equitable right in the subject-matter of the contract"). Indeed, the concepts of lienholder and property owner necessarily are mutually exclusive, since a property owner cannot have a lien on his own property. See *Black's Law Dictionary*, *supra*, at 933. That States such as Oregon or Alabama grant attorneys somewhat broader powers than other States to enforce their liens does not make the attorneys co-owners of their clients' claims.

Oregon's attorney lien statute, moreover, like those of most States, draws no distinction between contingent fees and fees based on an hourly rate. Regardless of the method of payment, the attorney is granted a lien for the amount of the fees. It necessarily follows, therefore, that Oregon's lien statute cannot provide a basis for providing contingent fees different tax treatment than hourly fees.

The non-proprietary nature of the Oregon attorney's lien statute, moreover, is confirmed by Oregon case law, which establishes that prior to a final judgment or decree, the client may compromise the action without

regard to any contract with the attorney. *Campbell's Automatic Safety Gas Burner Co.* v. *Hammer*, 153 P. 475, 478 (Or. 1915); *Jackson* v. *Stearns*, 84 P. 798, 800 (Or. 1906); see also *Potter* v. *Schlesser Co.*, 63 P.3d 1172, 1174 (Or. 2003) (giving the term "lien" in Section 87.445 "its ordinary meaning," namely, a "charge upon real or personal property for the satisfaction of some debt or duty ordinarily arising by operation of law" (quoting *Webster's Third New Int'l Dictionary* 1306 (unabridged ed. 1993))).

Further evidence that the client, not the attorney, owns the cause of action in Oregon is provided by the fact that "[a]n attorney * * * cannot lawfully purchase a claim for the consideration that he will prosecute it in his own name for a part of the amount recovered. He has no right to become attorney and client at the same time. The courts will not aid him to carry out any such questionable scheme, or recognize the legitimacy of the attempted speculation." *Craig* v. *Maher*, 74 P.2d 396, 399 (Or. 1937) (quoting *Dahms* v. *Sears*, 11 P. 891, 898 (Or. 1886)). And the client can choose not to appeal an adverse trial court judgment against his attorney's wishes. *In re Grimes' Estate*, 131 P.2d 448, 454 (Or. 1942); *Smith* v. *United States Nat'l Bank*, 615 P.2d 1119, 1123 (Or. Ct. App. 1980).

Accordingly, under Oregon law, respondent Banaitis was the sole owner of his cause of action, and as such retained ultimate authority to decide whether and when to settle his claims and for how much. That fact is reflected in the terms of the retainer agreement between respondent and his attorney, which provides that the "[a]ttorney will obtain [respondent's] approval before acceptance or rejection of a settlement on [respondent's] behalf." J.A. 95. Respondent therefore enjoyed substantial control over the amount and timing of the

contingent fee. Thus, even assuming *arguendo* that under Oregon law a contingent fee agreement could be considered to be an assignment by the client to his attorney of a portion of the income that the client expects to realize in the future, it is clear that the client retains sufficient control and obtains sufficient gain from the agreement to require inclusion of the contingent-fee portion of any taxable litigation award in the client's gross income.

CONCLUSION

The judgments of the courts of appeals should be reversed with respect to the issue of the tax treatment of contingent attorney's fees.

Respectfully submitted.

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JUNE 2004

26 U.S.C. 61. GROSS INCOME DEFINED

(a) General Definition.

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

Or. Rev. Stat. § 87.445. Liens upon actions or judgments

An attorney has a lien upon actions, suits and proceedings after the commencement thereof, and judgments, decrees, orders and awards entered therein in the client's favor and the proceeds thereof to the extent of fees and compensation specially agreed upon with the client, or if there is no agreement, for the reasonable value of the services of the attorney.

No. 03-892

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN W. BANKS, II, RESPONDENT

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether, under Section 61(a) of the Internal Revenue Code, 26 U.S.C. § 61(a), a discrimination plaintiff's gross income from the proceeds of litigation includes the portion of a damages recovery that is paid to his attorney pursuant to a contingent fee agreement.

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IN THE SUPREME COURT OF THE UNITED STATES

NO. 03-892

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

V.

JOHN W. BANKS, II, RESPONDENT

ON WRIT OF CERTIORARI
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BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a–33a) is reported at 345 F.3d 373. The opinion of the Tax Court (Pet. App. 34a-57a) is a memorandum decision, T.C. Memo. 2001-48 (Feb. 28, 2001), unofficially reported at 81 T.C.M. (CCH) 1219.

JURISDICTION

The judgment of the court of appeals was filed on September 30, 2003. The petition for certiorari was filed on December 19, 2003. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATEMENT

1. In 1984, Respondent John W. Banks, II, filed a federal civil rights employment discrimination lawsuit against his former employer, the California Department of Education ("CDOE"). Mr. Banks, through his attorney, filed two amended complaints and a second lawsuit. Mr. Banks's second amended complaint alleged, *inter alia*, violations by the CDOE of: (1) Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. § 2000e *et seq.*; (2) 42 U.S.C. § 1981; and (3) 42 U.S.C. § 1983. Pet. App. 2a. The two lawsuits were consolidated. Shortly after trial began in 1990, the parties settled all of the claims for $464,000. Pursuant to a contingent fee contract Mr. Banks entered into with his attorney before the commencement of the lawsuit, $150,000 of the settlement amount was retained by Mr. Banks's attorney. Pet. App. 1a-5a.

2. In 1997, the Commissioner issued a Notice of Deficiency to Mr. Banks for the 1990 tax year. In the Notice, the Commissioner asserted that the portion of the settlement proceeds retained by Mr. Banks's attorney under the contingent fee contract also constituted taxable income to Mr. Banks. Mr. Banks filed a timely petition with the United States Tax Court challenging the Commissioner's determination. Pet. App. 6a.

3. The Tax Court upheld the Commissioner's determination that the portion of the settlement proceeds retained by Mr. Banks's attorney as a contingent fee also constituted taxable income to Mr. Banks. Pet. App. 52a.

4. Mr. Banks appealed the Tax Court's decision. Relying on its previous decision in *Estate of Clarks v. Commissioner*, 202 F.3d 854 (6th Cir. 2000), the court of appeals reversed the Tax Court with respect to the

contingent fee issue. Pet. App. 17a-25a.[1] In *Estate of Clarks*, the court of appeals held that the assignment of income doctrine does not require that a taxpayer include in his gross income the attorney's contingent fee portion of a litigation recovery. Consistent with *Estate of Clarks*, the court of appeals held that the portion of the settlement retained by Mr. Banks's attorney as a contingent fee was not income to Mr. Banks. Pet. App. 25a.

SUMMARY OF ARGUMENT

1. This Court has long taught that "[c]ommon understanding and experience are the touchstones for interpretation of the revenue laws." *Helvering v. Horst*, 311 U.S. 112, 118 (1940). The Commissioner's position in this case violates that principle. He asserts that a contingent fee plaintiff in a federal discrimination case must include in income not only his net recovery, but the contingent fee paid to his attorney. While conceding that this rule produces harsh results, the Commissioner concludes that the assignment of income doctrine, a court-made anti-abuse rule, requires such a result. However, to compel the plaintiff to pay taxes on income earned and enjoyed by his attorney and on which his attorney also pays taxes contravenes any notion of "common understanding and experience," and is fundamentally in conflict with the decisions of this Court that created the assignment of income doctrine.

2. No provision in the Internal Revenue Code requires that a federal employment discrimination plaintiff such as Mr. Banks include in his gross income

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[1] The court of appeals below also relied upon the Fifth Circuit's decision in favor of the taxpayer in *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000). Pet. App. 23a; *accord Foster v. United States*, 249 F.3d 1275 (11th Cir. 2001).

the portion of his settlement earned by, retained by, and taxed to his attorney as a contingent fee. Section 61(a) defines "gross income" as "all income from whatever source derived." What constitutes "income" for purposes of Section 61(a) is the subject of a long line of judicial decisions, many from this Court, none of which support the Commissioner's position here.

In those cases, the courts have established the dominion and control test, *i.e.*, that income is charged to a taxpayer where the taxpayer receives, controls or has power of disposition over an item of receipt. Prior to retaining counsel, Mr. Banks, as a practical matter, had no hope of recovering anything from his speculative claim. To obtain competent counsel who would share the risk that the claim would fail, Mr. Banks retained an attorney by entering into a contingent fee contract. As the court of appeals below correctly determined, Mr. Banks, by engaging an attorney to pursue his claims, and by entering into a contingent fee contract with that attorney, ceded control over that portion of his recovery. Pet. App. 24a-25a. Mr. Banks's attorney, through his own skill and effort, made the recovery possible. Mr. Banks had no right to divest his attorney of the portion of the recovery rightfully retained by the attorney as a contingent fee. Thus, under the proper application of the dominion and control test, that portion of the recovery is not income to Mr. Banks.

3. The court of appeals below determined, and the parties do not dispute, that the amount paid by Mr. Banks's former employer in settlement of his lawsuit was attributable to Mr. Banks's Title VII federal employment discrimination claims and his federal civil rights claims he had plead under 42 U.S.C. § 1981 and 42 U.S.C. § 1983. Pet. App. 17a-25a. Amounts received in settlement of a lawsuit are taxed the same as a successful judgment would have been taxed. The federal statutes

under which Mr. Banks brought his claims contained "fee-shifting" provisions, under which the federal district court could have awarded attorney's fees had Mr. Banks obtained a judgment. 42 U.S.C. § 2000e-5(k); 42 U.S.C. § 1988. A portion of the settlement paid by the CDOE to Mr. Banks was therefore necessarily paid in lieu of any potential recovery and award for fees under these fee-shifting provisions. Because attorney's fees awarded under the fee-shifting statutes should not give rise to income for a prevailing plaintiff, Mr. Banks should not be charged with income on the amounts paid to him and his attorney by the CDOE to avoid potential liability under the fee-shifting statutes.

This Court has made clear that Congress' purpose in enacting fee-shifting statutes was to encourage a litigant such as Mr. Banks, acting in his capacity as a "private attorney general," to vindicate public policy with respect to the federal civil rights or other laws. However, the Commissioner's position in this case has the effect of deterring federal civil rights claimants and other federal and state claimants from bringing meritorious claims.

Even more unsettling about the Commissioner's position in this case is that it has actually led, in at least one instance, to a federal employment discrimination plaintiff owing more in tax than her net recovery in litigation. Such an absurd and patently unjust result cannot be accepted, particularly since no provision in the Internal Revenue Code requires it.

The Commissioner does not confront this issue square-on in his brief, but hints that such a result is mandated by the Alternative Minimum Tax (AMT). Pet. Br. 25. The AMT disallows certain deductions, such as legal expenses, in arriving at alternative minimum taxable income. As applied to a contingent fee contract, however, the AMT, which operates to allow certain *deductions*, is a moot

issue unless it is first determined that the contingent fee portion of a litigation recovery is gross *income* to the plaintiff.

The attorney's portion of a recovery should not be treated as income. A contingent fee arrangement is the economic equivalent of a joint venture between the plaintiff and his attorney. A successful plaintiff thus should not be charged with the income earned by and paid to his effective joint venturer, his attorney.

4a. The Commissioner's position that the contingent fee portion of a litigation recovery is includible in a plaintiff's gross income rests exclusively on the misapplication of a court-made anti-abuse rule, *i.e.*, the assignment of income doctrine. That doctrine has no application to a contingent fee contract, which is an arm's length transaction not involving any tax avoidance purpose. Pet. App. 24a. The assignment of income doctrine originated as a judicial anti-abuse rule, and was designed to prevent high bracket taxpayers from shifting income to lower bracket family members. Two main lines of assignment of income cases developed, both of which actually support the taxpayer here.

Lucas v. Earl, 281 U.S. 111 (1930) is the landmark case of this Court dealing with the assignment of income from services. In that case, this Court held that the taxpayer could not escape the bite of the marginal tax structure by assigning half of his income to his lower bracket taxpayer wife. Justice Holmes, writing for this Court, made it clear that income is properly taxed to the person who earns it, *i.e.*, under the facts in that case, the husband. In this case, it is clear that Mr. Banks did not earn the attorney's fee portion of the settlement; his attorney did. As a layperson, Mr. Banks's entire discrimination claim was practically worthless without his employing the services of a skillful attorney. The price

he paid for that attorney was, effectively, a portion of that otherwise worthless claim. The attorney's personal services converted Mr. Banks's claim into money and Mr. Banks received the settlement proceeds less the contingent fee. At no time did Mr. Banks have the ability to receive or to exercise power of disposition over the contingent fee. That portion of the settlement was worthless before retention of counsel and irrevocably forsaken by Mr. Banks after signing the contingent fee contract. In sum, Mr. Banks's attorney, not Mr. Banks, earned and properly retained the contingent fee.

The second main line of cases dealing with the assignment of income involves transfers of income from property. The principle emerging from these cases is plain: the price that must be paid by the transferor of income from property in order to effectively assign the income from property is that he must transfer the income-producing property itself, not just the income. *Blair v. Commissioner*, 300 U.S. 5 (1937); *Helvering v. Horst*, 311 U.S. 112 (1940). The taxpayer has done just that in this case. The income-producing property is Mr. Banks's discrimination claim. Pursuant to the contingent fee contract, Mr. Banks, in effect, surrendered the contingent fee portion of the claim to his attorney. He no longer had the right to assign it to anyone else or, for that matter, control its disposition in any way.

Application of the assignment of income doctrine in Mr. Banks's case is inconsistent with the rationale of the case law which engendered that doctrine. Mr. Banks's attorney, not Mr. Banks, earned the contingent fee. When he entered into the contingent fee contract, Mr. Banks effectively surrendered an undivided interest in his claim, the income-producing property. No tax avoidance purpose was afoot. Under either line of assignment of income cases, Mr. Banks must prevail and the decision of the court of appeals below should be affirmed.

4b. The Commissioner defends his position by relying on *Old Colony Trust v. Commissioner*, 279 U.S. 716, 729 (1929), where this Court held that the satisfaction of a taxpayer's debt by a payment made by a third party directly to the taxpayer's creditor is income to the taxpayer. That case, however, is inapposite here. A contingent fee plaintiff owes no "debt" to his attorney that is "discharged" by the defendant. *Cotnam v. Commissioner*, 263 F.2d 119, 126 (5th Cir. 1959). Instead, a contingent fee plaintiff, in hope of recovering on his claim, surrenders a portion of it to his attorney. In the event the attorney's efforts result in a recovery, through either judgment or settlement, the attorney receives his fee from the defendant, and no debtor-creditor relationship between the attorney and his client ever arises. If there is no recovery, then the attorney is not entitled to a fee; *a fortiori*, no debtor-creditor relationship exists.

4c. This Court has admonished that double taxation is not to be presumed with respect to a transaction absent a clear expression of congressional intent to the contrary. Yet, the Commissioner's position, if followed, results in double taxation. A contingent fee client and his attorney will both be taxed on the same item. No provision of the Internal Revenue Code requires this result. Moreover, under the classic intra-family assignment of income cases upon which the Commissioner relies (*Earl* and *Horst*), the only question before the court was *which* taxpayer was liable, the high tax bracket assignor, or the lower tax bracket assignee. Those cases thus do not stand, as the Commissioner suggests, for the principle that *both* the assignor and assignee can be taxed on the same funds.

In sum, this Court created the assignment of income doctrine to prevent the shifting of income from high bracket taxpayers to lower bracket taxpayers. It never

contemplated the misapplication of that doctrine to produce the results pursued here by the Commissioner. Moreover, the assignment of income doctrine is a *judicial* doctrine, not a constitutional construct, nor a statutory command of Congress, nor an immutable law. This doctrine should be applied in such a manner that it accomplishes its original purpose, and not produce unjust results, results which undermine other federal laws.

ARGUMENT

I. NO PROVISION OF THE INTERNAL REVENUE CODE REQUIRES MR. BANKS TO RECOGNIZE INCOME PROPERLY ALLOCABLE TO HIS ATTORNEY.

The dispute in this case is over whether the portion of the settlement in Mr. Banks's federal civil rights lawsuit against the California Department of Education that was earned by, retained by, and taxed to Mr. Banks's attorney as a contingent fee constitutes gross income to Mr. Banks pursuant to section 61(a)[2] of the Internal Revenue Code. Importantly, section 61(a) itself does not supply an answer to this question.

Section 63(a) defines "taxable income" as "gross income" less certain enumerated deductions. Section 61(a) defines "gross income" as "all income from whatever source derived." Because of the circular and self-referential nature of section 61(a), whether the portion of Mr. Banks's settlement earned and retained by Mr. Banks's attorney as a contingent fee is income to Mr. Banks must be based on a judicial interpretation of the term "income."

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[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, 26 U.S.C. § 1 *et seq.*, as amended and in effect during the relevant period.

This Court's decisions have made clear that control or power of disposition of an item of receipt is a prerequisite to charging a taxpayer with income. As explained in the following section, Mr. Banks *never* had control or power of disposition over the contingent fee portion of the settlement.

In addition, as explained in Section III, the Commissioner's position has the effect of deterring plaintiffs from prosecuting meritorious claims under Title VII and other various federal and state laws which contain fee-shifting provisions. Moreover, as explained in Section IV, the Commissioner's position leads to grievously unjust results, such as an employment discrimination plaintiff actually owing more money in federal income tax than her net recovery in litigation. Finally, as explained in Section V, *infra*, contrary to the Commissioner's assertions, the assignment of income doctrine, a judicial anti-abuse rule, does not apply to an attorney contingent fee contract, which is an arm's length transaction, akin to a joint venture, not involving any tax avoidance purpose.

The absence of statutory language indicating that a successful federal discrimination plaintiff such as Mr. Banks must include his attorney's fees in his own income, combined with the plentiful reasons for *not* including those fees in Mr. Banks's income, present a compelling case for affirming the court of appeals' decision in favor of Mr. Banks.

II. THE PORTION OF THE SETTLEMENT EARNED BY, RETAINED BY, AND TAXED TO MR. BANKS'S ATTORNEY—THE CONTINGENT FEE—CANNOT BE INCOME TO MR. BANKS BECAUSE MR. BANKS LACKED THE REQUISITE DOMINION, CONTROL, AND BENEFICIAL OWNERSHIP OVER THAT PORTION OF THE RECOVERY.

In determining what constitutes "income" for purposes of section 61(a), this Court has long established that unfettered control is the hallmark of income:

> It is not enough to trace income to the property which is its true source, a matter which may become more metaphysical than legal. Nor is the tax problem with which we are concerned necessarily answered by the fact that such property, if it can be properly identified, has been assigned. The crucial question remains whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes.

Commissioner v. Sunnen, 331 U.S. 591, 604 (1948).[3] This Court has also summarized the control test as follows:

> [T]axation is not so much concerned with the refinements of title as it is with *actual command over the property taxed*—the actual benefit for which the tax is paid. * * * The income that is subject to a man's *unfettered command* and that he is free to enjoy at his own option may be taxed to him as his income, whether he sees fit to enjoy it or not.

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[3] As a preliminary matter, it is worth noting that the Commissioner now agrees with Mr. Banks that federal, not state law controls this issue. *See* Pet. Br. 15-18.

Corliss v. Bowers, 281 U.S. 376, 378 (1930) (Holmes, J.) (emphasis added). Put another way, in order to qualify as "income", the payments received must be "undeniable accessions to wealth, clearly realized, and over which the taxpayers have *complete dominion*." *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203, 209 (1990) (quoting *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431 (1955)) (emphasis added). The "key" to determining whether a taxpayer enjoys "complete dominion" is "whether the taxpayer has some guarantee he will be allowed to keep the money." *Indianapolis Power & Light Co.*, 493 U.S. at 210.

The primary authorities relied upon by the Commissioner actually support the taxpayer in this case. In *Lucas v. Earl*, 281 U.S. 111 (1930), involving the assignment of income from personal services, the taxpayer, unlike here, had control over the flow of income, both before and after the assignment of a portion of that income to his wife, by regulating the amount of services he performed. And while the taxpayer lost the ability to receive a portion of the income after assignment, he had total control over the income flow at the time of assignment.

Likewise, in *Helvering v. Horst*, 311 U.S. 112 (1940), involving the assignment of income from property, the taxpayer, unlike here, had total control over the future income from interest coupons attached to negotiable bonds. It is true that, after the taxpayer gave the coupons to his son, the taxpayer no longer had a right to receive interest payments. However, after the taxpayer purchased the bonds, the interest payments were virtually *certain* to be paid. *Id.* at 119-20 ("[H]ere the right of the assignor to receive the income antedated the assignment which transferred the right."). Thus, it was the taxpayer's very act of giving the interest coupons away that constituted the exercise of the power of

disposition of that income that caused him to realize income. *Id.* at 115 ("Here respondent, as owner of the bonds, had acquired the legal right to demand payment at maturity of the interest specified by the coupons and the power to command its payment to others, which constituted an economic gain to him.")

The facts in this case are dramatically different from the facts in the cases relied on by the Commissioner. By entering into a contingent fee contract, Mr. Banks ceded all practical control over the disposition of the contingent fee portion of any potential future recovery earned by his attorney. In addition, Mr. Banks never had any *de facto* ability to obtain *any* recovery without the assistance of counsel. Mr. Banks was not an attorney, and no authority need be cited for the fact that it is unlikely that he could have successfully prosecuted his claims in federal district court.[4] This is in marked contrast to *Horst*, *supra*, where the bond interest payments that were the subject of the transfer were virtually certain to be paid out. This also is in marked contrast to *Earl*, *supra*, where it was the *assignor* who earned the income that was the subject of assignment. In a contingent fee arrangement, it is the *assignee*—the attorney—whose skill and efforts produce a recovery from a speculative claim. *Estate of Clarks v. United States*, 202 F.3d 854, 857 (6th Cir. 2000) (distinguishing *Earl* and explaining that, in a contingent fee arrangement "the lawyer's income is the result of his *own* personal skill and judgment, not the skill or largess of a family member who wants to split his income to avoid taxation") (emphasis added).

The contingent fee contract Mr. Banks entered into with his attorney operated to shift practical and legal

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[4] A decision in favor of the Commissioner in this case will require many discrimination plaintiffs to do just that in order to avoid incurring a net loss upon a "successful" prosecution of their claims. *See* Sections III and IV, *infra*.

control of the contingent fee portion of the settlement proceeds from Mr. Banks to his attorney. Under California law, the assignment to Mr. Banks's attorney operated as a lien on the contingent fee portion of any potential recovery. *Isrin v. Super. Ct.*, 403 P.2d 728 (Cal. 1965). Mr. Banks thus did not have uncontrolled discretion over the portion of the settlement proceeds earned and rightfully retained by his attorney; he had no right to divest his attorney of the contingent fee portion of the settlement proceeds. Accordingly, that portion of the settlement proceeds cannot be income to Mr. Banks.

Cotnam v. Commissioner, 263 F.2d 119 (5th Cir. 1959), was the first case to address the applicability of the assignment of income doctrine to attorney contingent fee contracts. The Fifth Circuit in that case concluded that, unlike the typical assignment of income situation, such as *Earl*, *supra*, where the assignor needs only to perform services to generate the income to be transferred, a plaintiff in a contingent fee situation, as a practical matter, can obtain a judgment or settlement only by ceding control of a portion of any potential recovery to his attorney:

> [The contingent fee plaintiff's] claim had no fair market value, and it was doubtful and uncertain as to whether it had any value. The only economic benefit she could then derive from her claim was to use a part of it in helping her to collect the remainder. Accordingly she, in effect, assigned to her attorneys forty per cent of the claim in order that she might collect the remaining sixty per cent. That was not the assignment of income of Mrs. Cotnam within the doctrine of *Lucas v. Earl*.

Id. at 125.

Similarly, the Sixth Circuit also considered the contingent fee plaintiff's lack of effective control over the fee portion of a settlement or judgment to be significant and likened the contingent fee arrangement to a joint venture. The Sixth Circuit concluded that a contingent fee arrangement is akin to a joint venture, correctly determining that only the attorney should include the fee in income. *Estate of Clarks*, 202 F.3d at 857; *see also* Pet. App. 24a (stating "taxpayer's claim was like a partnership or joint venture in which the taxpayer assigned away one-third in hope of recovering two-thirds"). The Sixth Circuit's analysis is supported by the Internal Revenue Code. Sections 761(a) and 7701(a)(2) both provide that the term "partnership" includes, *inter alia*, a joint venture through or by means of which any business, financial operation, or venture is carried on. "The tax definition of a 'partnership' is broad and imprecise, embracing every jointly owned, profit-oriented arrangement that is not a corporation, trust, or estate, whether or not the arrangement constitutes a state law partnership." William S. McKee, *et al.*, FEDERAL TAXATION OF PARTNERSHIPS & PARTNERS, vol. 1, ¶ 3.02 (3d ed., Warren, Gorham & Lamont of RIA, 1997 & Supp. 2004) [citing sections 761(a) and 7701(a)(2)].

The Sixth Circuit's holdings are consistent with the statutory provisions governing the taxation of partners. Section 61(a)(13) provides that gross income includes an individual's distributive share of partnership gross income. Section 704(a) provides, in general, that a partner's distributive share of income shall be determined by the partnership agreement subject to the requirement in section 704(b) that the agreement has substantial economic effect. The contingent fee agreement between Mr. Banks and his attorney reflected the economic reality that Mr. Banks's claim was not recoverable without a skilled attorney who would expend substantial efforts,

and incur the risk that his efforts would go unremunerated if the claim failed.

Indeed, the economic substance of a contingent fee arrangement has all the essential elements of a joint venture. First, the client contributes the inchoate claim, and under the contingent fee arrangement, the attorney, through his skill and effort, adds value to the asset (*i.e.*, by prosecuting the lawsuit). Second, it is the attorney and attorney alone who earns the contingent fee portion of any recovery. This is in fundamental contrast to *Earl*, *supra*, where it was the *assignor*, not the assignee, who earned the income subject to assignment. Third, the attorney incurs a substantial risk in the venture, namely, that, absent recovery, he will not be paid. Fourth, the attorney has a *bona fide* property interest in the contingent fee portion of the recovery. Neither the plaintiff, nor anyone else, has a right to divest the attorney of the portion of the recovery earned and retained as a contingent fee. The attorney, in effect, has a right to exclude others from that portion of the recovery, and it is that very right to exclude which this Court has recognized is the hallmark of a property interest. *College Savings Bank v. Florida Prepaid Postsecondary Education Expense Bd.*, 527 U.S. 666, 673 (1999) (stating "The hallmark of a protected property interest is the right to exclude others. That is 'one of the most essential sticks in the bundle of rights that are commonly characterized as property.'") (quoting *Kaiser Aetna v. United States*, 444 U.S. 164, 176 (1979)).

In sum, the relationship between Mr. Banks and his attorney was effectively that of joint venturers. Like joint venturers, each should be taxed only on the amount he received.

The Commissioner contends that a plaintiff who pledges a portion of a potential recovery to his attorney as

a contingent fee still has sufficient control to be charged with income on that portion because he retains the right to dismiss the lawsuit and to authorize settlement. Pet. Br. 32. This argument misses the point. The critical question is not whether a contingent fee plaintiff like Mr. Banks transferred title to *all* of his rights as a plaintiff to his attorney. Rather, the critical question is whether Mr. Banks had "complete dominion" (*Glenshaw Glass*, 348 U.S. at 431) or "unfettered command" (*Corliss*, 281 U.S. at 378) over the assigned property. It is plain that he did not. Hypothetically, Mr. Banks could have obstreperously refused to accept his attorney's recommendation to settle, thereby preventing (at least temporarily) his attorney from receiving his contingent fee. At no time, however, was Mr. Banks in a position to receive the fee himself or direct that it be paid to anyone else.

Mr. Banks cannot be charged with income from an item that he neither received nor could have received. *Commissioner v. First Security Bank of Utah*, 405 U.S. 394, 403 (1972) ("We know of no decision of this Court wherein a person has been found to have taxable income that he did not receive and that he was prohibited from receiving. * * * The underlying assumption always has been that in order to be taxed for income, a taxpayer must have *complete dominion* over it.") (emphasis added). By entering into the contingent fee contract with his attorney, Mr. Banks ceded substantial control over his lawsuit, and *all* control over the portion attributable to the contingent fee earned and retained by his attorney. Accordingly, under this Court's precedents, Mr. Banks lacked the necessary dominion and control over the contingent fee portion of the settlement, *both before and after* entering into the contingent fee contract, to be charged with income on that portion.

III. THE ATTORNEY'S FEES PORTION OF THE SETTLEMENT WAS IN LIEU OF AMOUNTS THAT COULD HAVE BEEN AWARDED UNDER FEE-SHIFTING STATUTES AND IS THEREFORE INCOME ONLY TO MR. BANKS'S ATTORNEY.

Amounts received in settlement of a legal claim are taxed the same as a judgment under that claim would have been taxed. The question is "in lieu of what" was the settlement paid. *Bagley v. Commissioner*, 105 T.C. 396, 406 (1995), *aff'd*, 121 F.3d 393 (8th Cir. 1997); *see also Woodward v. Commissioner*, 397 U.S. 572, 578 (1970); *United States v. Gilmore*, 372 U.S. 39, 48 (1963); Treas. Reg. § 1.104-1(c) (section 104(a)(2) exclusion for amounts received on account of personal injuries or sickness applies to amounts received through a settlement agreement entered into in lieu of such prosecution).

The court of appeals below determined that the settlement received by Mr. Banks and his attorney was in lieu of claims under (1) Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. § 2000e *et seq.*; (2) 42 U.S.C. § 1981; and (3) 42 U.S.C. § 1983. Pet. App. 2a-3a, 10a-17a. This holding has not been challenged by the parties. Accordingly, the taxation of the settlement payment received by Mr. Banks and his attorney is controlled by the tax treatment of recoveries under those statutes.

Each of the statutes under which Mr. Banks could have recovered contains a "fee-shifting" provision which enables a court to award attorneys fees to those who successfully prosecute claims. *See* 42 U.S.C. § 2000e-5(k), 42 U.S.C. § 1988. A portion of the settlement paid to Mr. Banks and his attorney was therefore necessarily paid in

lieu of any potential recovery under those fee-shifting statutes.[5]

An amount awarded by a court under a fee-shifting statute is properly income only to the attorney who receives the awarded fees from the defendant. *Cf. Porter v. United States Agency for Int'l Dev.*, 293 F. Supp. 2d 152 (D.D.C. 2003). The court-awarded attorney's fees are separate and distinct from any award intended to compensate the prevailing plaintiff. The fee-shifting statutes simply put the burden of some of the costs of litigation on the defendant by requiring the defendant to pay the plaintiff's attorney's reasonable fees. The defendant's payment to the plaintiff's attorney does not represent an accession to the plaintiff's wealth, and should not be treated as income to the plaintiff under section 61(a).

As a civil rights plaintiff, Mr. Banks was acting as a "private attorney general," vindicating public policy, when he pursued his claims against the CDOE. *See Newman v. Piggie Park Enterprises*, 390 U.S. 400, 402 (1968). Congress chose to encourage suits like Mr. Banks's by enacting fee-shifting statutes under which a court could require the CDOE to pay Mr. Banks's attorney's reasonable fees. *See Venegas v. Mitchell*, 495 U.S. 82, 86 (1990). Partly to eliminate the possibility of a court requiring it to pay Mr. Banks's attorney, the CDOE settled the case.

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[5] There is no reason that a litigant who opts to settle his case, such as Mr. Banks, and whose attorney is paid pursuant to a contingent fee contract, should be treated any differently for tax purposes than a litigant who recovers attorney's fees pursuant to a federal fee-shifting statute. Such a position, if adopted by this Court, would contravene previous decisions of this Court recognizing that Congress intended to encourage settlement of employment discrimination disputes. *Burlington Industries, Inc. v. Ellerth*, 524 U.S. 742, 764 (1998); *EEOC v. Shell Oil, Inc.*, 466 U.S. 54, 57 (1984).

The approach advocated by the Commissioner in this case would punish civil rights litigants who answer Congress's call and assume the role of "private attorneys general." Charging Mr. Banks with income on the portion of the settlement attributable to CDOE's extinguishment of its potential obligation to pay Mr. Banks's attorney undermines the civil rights statutes.[6] Mr. Banks should properly only recognize income on the portion of the settlement that he actually received and of which he enjoyed the economic benefit.

IV. THE COMMISSIONER'S POSITION LEADS TO ABSURD AND GRIEVOUSLY UNJUST RESULTS, AND HAS CAUSED A CONTINGENT FEE PLAINTIFF TO OWE MORE IN TAX THAN HER ENTIRE NET RECOVERY.

As explained above, the Commissioner's position in this case is neither supported by any provision of the Internal Revenue Code, nor by any of the cases of this Court interpreting the term "income" for purposes of

[6] Mr. Banks's contingent fee contract was controlled by California law. A decision in favor of the Commissioner by this Court would have the consequence of undermining the California Supreme Court's determination that attorney's fees awarded pursuant to a California fee-shifting provision, Cal. Gov't Code § 12965 (part of the California Fair Employment and Housing Act (FEHA), Cal. Gov't Code § 12900 *et seq.*), belong *exclusively* to a FEHA claimant's attorney, absent an enforceable contract to the contrary. *See Flannery v. Prentice*, 28 P.3d 860 (Cal. 2001). Under *Flannery*, there is no basis for contending that a FEHA claimant has *any* control, for federal tax purposes, over an attorney's fee awarded pursuant to the FEHA fee-shifting statute to be charged with federal income tax. Such claimants should not be charged with federal income tax on those amounts that they do not control. However, should the Court rule against Mr. Banks in this case, it would have collateral consequences for FEHA claimants pursuing their discrimination claims under state law. FEHA claimants, due to federal income tax considerations, would have less incentive to settle their state claims.

section 61(a). But perhaps most striking of all about the Commissioner's position, which is based entirely on a judicial anti-abuse rule, is the harsh and absurd results it foists upon certain federal and state litigants in discrimination and other actions. There is no reason to accept these results, especially in light of the fact that they are not compelled by any provision in the text of the Internal Revenue Code.

As chronicled in the *New York Times*, Cynthia Spina, a law enforcement officer employed by the Forest Preserve District of Cook County, Illinois, sued her employer for sex discrimination and harassment. Adam Liptak, "Tax Bill Exceeds Award to Officer in Sex Bias Suit," NEW YORK TIMES, August 11, 2002, at section 1, column 5, p. 18; *see also Spina v. Forest Preserve District of Cook County*, 207 F. Supp. 2d 764 (N.D. Ill. 2002). Ms. Spina recovered an award of $300,000, in addition to about $850,000 in attorney's fees and $100,000 in costs. After all was said and done, Ms. Spina's tax bill consumed her *entire* $300,000 recovery, and she actually wound up *owing* the Commissioner $99,000.

In his carefully-reasoned and lengthy (38-page) dissent in *Kenseth v. Commissioner*, 114 T.C. 399, 421-58 (2000), Judge Beghe, *inter alia*, forewarned that the Commissioner's untenable position would lead to the absurd result in Ms. Spina's case: "[I]n cases in which the aggregate fees exceed 72-73 pereent of the recovery, the tax can exceed the net recovery, resulting in an overall effective rate of tax that exceeds 100 percent of the net recovery." *Id.* at 425-26. Such a result, however, can occur only if, as a threshold matter, it is determined that the attorney's fee portion of Ms. Spina's award is "income" to her under section 61(a). Once that determination is reached, the Alternative Minimum Tax (AMT) provisions of the Internal Revenue Code, 26 U.S.C. §§ 55-59, operate to disallow her any deduction of her attorney's fees.

The Commissioner cannot seriously maintain that the result in Ms. Spina's case is merely the unfortunate result of a mechanical application of the tax laws enacted by Congress, specifically the AMT. Nothing in the text of the Internal Revenue Code mandates the result in Ms. Spina's case. The AMT, *inter alia*, operates to impose a statutory limit or bar on certain types of *deductions* claimed by a taxpayer. Application of the AMT provisions, however, is a moot issue unless it is initially determined that the attorney's fee portion of her recovery is gross income to her under section 61(a). As explained more fully in Section V, *infra*, the Commissioner bases his determination that the attorney's fee portion of a recovery is includible in a plaintiff's gross income entirely on the assignment of income doctrine—a court-made anti-abuse rule. The result in Ms. Spina's case thus rests entirely on the erroneous application of a judicial doctrine. This is why Mr. Banks plainly is *not* asking this Court to disregard, for equitable reasons, any of the statutory requirements or computational steps mandated by the AMT.

The Commissioner's position ultimately has the chilling effect of discouraging federal civil rights plaintiffs from bringing meritorious claims. The assignment of income doctrine, a court-created anti-abuse rule, should not be used to reach such results. It is revealing that the Commissioner's brief does not address the manifestly unjust results in cases such as Ms. Spina's, results compelled by the Commissioner's position in this case.

V. THE ASSIGNMENT OF INCOME DOCTRINE IS A COURT-CREATED ANTI-ABUSE RULE THAT DOES NOT APPLY TO AN ATTORNEY CONTINGENT FEE CONTRACT.

A. A Contingent Fee Contract Is Fundamentally Distinguishable From The Classic Intra-Family Assignments Of Income Present in Such Cases As *Earl* And *Horst*.

The Commissioner does not identify *any* provision of the Internal Revenue Code that expressly provides that a discrimination claimant like Mr. Banks must include in his gross income the portion of the recovery earned and retained by his attorney as a contingent fee. Instead, the Commissioner relies exclusively upon a judicially-created anti-abuse rule known as the assignment of income doctrine.

Because the federal income tax is progressive, taxpayers have sometimes attempted to shift income to lower bracket taxpayers. Section 61 defines income but, notably, does not indicate how to determine who is the appropriate taxpayer. Nevertheless, the courts, and, in particular, this Court, have filled the breach by adopting certain principles to determine who should report an item of income that is transferred from one taxpayer to another. The term "assignment of income doctrine" was the label affixed to these principles.

In this case, the Commissioner has turned the assignment of income doctrine inside-out by asserting that it requires Mr. Banks to report his attorney's contingent fee as income of his own. The assignment of income doctrine originated in cases such as *Lucas v. Earl*, 281 U.S. 111 (1930), and *Helvering v. Horst*, 311 U.S. 112 (1940), and has developed as a judicial anti-abuse rule

designed to prevent high bracket taxpayers from shifting income to lower bracket family members to avoid paying income tax at a higher marginal rate. *See United States v. Basye*, 410 U.S. 441, 450 (1973) (stating "[t]he principle of *Lucas v. Earl*, that he who earns income may not avoid taxation through anticipatory arrangements no matter how clever or subtle, has been repeatedly invoked by this Court and stands today as a cornerstone of our graduated income tax system").

A contingent fee contract, however, is an arm's length transaction not involving any tax avoidance purpose. The assignment of income doctrine thus does not apply to such an arrangement. Pet. App. 24a; *Estate of Clarks*, *supra*, 202 F.3d at 857; *Cotnam*, *supra*, 263 F.2d at 126. There is no reason to apply this anti-abuse rule to tax Mr. Banks on income earned by the skill and efforts of his attorney, that Mr. Banks never received, and which Mr. Banks never was legally entitled to receive.

Two main lines of assignment of income cases have developed, one dealing with the assignment of income from services and the other with the assignment of income from property. Under either line of cases, Mr. Banks should prevail. With respect to the assignment of income from services, this Court held in *Earl*, *supra*, that a taxpayer could not escape the bite of the progressive tax structure by splitting income he earned with his lower income bracket wife. Writing for the Court, Justice Holmes explained that a taxpayer could not avoid taxation through such clever diversions:

> [T]he tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who *earned* it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

281 U.S. at 115 (emphasis added).[7] The fundamental principle from *Earl* is clear: income is taxed to the person who *earns* it. The facts of this case are equally clear: Mr. Banks's attorney earned the contingent fee and the income from that portion of the recovery is Mr. Banks's attorney's alone to report. Pet. App. 22a ("unlike the *Earl* * * * assignee[ ] who performed no services to earn [her] income, the attorney earned his income because the income resulted from his own skill and judgment"); *Estate of Clarks*, 202 F.3d at 858 ("The income should be charged to the one who earned it and received it, not as under the government's theory of the case, to one who neither received it nor earned it").

In sum, if this case is viewed as an attempted assignment of income from services, then the taxpayer must prevail. Mr. Banks performed no services to earn the contingent fee. Those services were provided solely by his attorney.

This Court has also held that income from *property* can be effectively assigned for federal income tax purposes but only at a price: control of the income-producing property must be relinquished as well. *Blair v. Commissioner*, 300 U.S. 5 (1937). In *Horst*, *supra*, a taxpayer attempted to avoid paying income tax on interest earned from negotiable bonds by assigning the detachable periodic interest coupons as a gift to his son

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[7] It may be true, as the Commissioner contends (Pet. Br. 33-34), that since the contract between Mr. Earl and his wife antedated the advent of the federal income tax, no tax avoidance motive was afoot. However, Mr. Earl's assignment had the effect of tax avoidance because of the progressivity of the income tax. As explained in detail in Section V(B), *infra*, the assignment of income doctrine is widely understood as a judicial anti-abuse rule.

prior to their maturity date. The Court rejected the taxpayer's reliance on *Blair* because Mr. Horst, unlike Mr. Blair, had retained ownership over the income-producing property (the bonds). 311 U.S. at 118-119.

If this case is to be viewed as an assignment of income from property, what is the property? It would have to be Mr. Banks's discrimination claim against his employer. By entering into the contingent fee contract, Mr. Banks effectively transferred an undivided interest in the attorney's fees portion of the income-producing property. Under *Blair*, the income from that property is charged to the transferee, his attorney. 300 U.S. at 12; *see also*, Daniel Q. Posin, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 5.02 at 340 (5th ed., West 2000) (explaining that, in *Blair*, "The father, in effect, chopped down some of his fruit and some of his tree and *gave some of his fruit and some of his tree to his children*. Such a 'vertical cut' was effective to shift the tax liability on the assigned income to the children.") (emphasis in original).

A contingent fee arrangement thus differs significantly from the transactions considered in the classic assignment of income cases. Unlike the situations in *Earl* and *Horst*, the value of the contingent fee portion of the claim assigned by Mr. Banks was (1) speculative and unaccrued at the time of transfer, (2) entirely dependent upon the efforts and skill of the assignee rather than the assignor, and (3) motivated by practical, non-tax considerations, not tax avoidance. These factors influenced the Sixth Circuit's decision to refuse to apply the assignment of income doctrine. *Estate of Clarks*, 202 F.3d at 857.

In *Earl*, this Court employed a tree-fruit metaphor to explain why a taxpayer could not shift income from services to his lower bracket wife: "no distinction can be made according to the arrangement by which fruits are

attributed to a different tree on which they grew." 281 U.S. at 115. The tree-fruit metaphor simply provides another way of stating that income must be attributed to the person who *earns* it. In *Earl* it was the husband (the tree) who earned the income (the fruit), and he could not escape taxation by assigning the fruit to his wife.

The tree-fruit metaphor is more descriptive of the circumstances where the assignment is one of property. A rental building (tree) generates rent (fruit); corporate stock (tree) generates dividends (fruit); and, as in *Horst*, a bond (tree) generates interest income (fruit). As noted earlier, the income (fruit) from income-producing property (tree) can be effectively transferred for federal income tax purposes if the transferor is willing to transfer the tree along with the fruit. Here, Mr. Banks effectively transferred an undivided interest in his discrimination claim (tree). Pet. App. 24a-25a ("[b]y signing the contingency fee agreement, [Mr. Banks] transferred some of the trees from the orchard, rather than simply transferring some of the orchard's fruit.") (citing *Estate of Clarks*, 202 F.3d at 858); *accord Cotnam*, *supra*, 263 F.2d at 126. As a result, the contingent fee (fruit) is solely the income of Mr. Banks's attorney.

In sum, the Commissioner's position in this case is at odds with the rationale of the relevant case law establishing the assignment of income doctrine. Mr. Banks's attorney, not Mr. Banks, earned the contingent fee. When he entered into the contingent fee contract, Mr. Banks effectively surrendered an undivided interest in his claim, the income-producing property. At the time of transfer, Mr. Banks's claims were speculative and unaccrued, and could be turned into recovery only through the effort of a skilled attorney. No tax avoidance purpose was afoot. Accordingly, the contingent fee portion of Mr. Banks's settlement is not income to him.

B. The Assignment Of Income Doctrine Is A Judicial Anti-Abuse Rule And Should Not Be Applied Here Because Mr. Banks's Motivation For Signing The Contingent Fee Contract Was Not To Avoid Taxes.

The Commissioner contends that the judicial assignment of income doctrine is not an anti-abuse rule. Pet. Br. 33-34. The Commissioner rests his assertion in part on the fact that in *Earl*, the husband and wife entered into the contract to split income prior to the advent of the federal income tax. Pet. Br. 33. While Mr. Earl himself might not have had a tax avoidance motive at the time he entered into the agreement, his assignment certainly *resulted* in tax avoidance after the establishment of the income tax. The facts in that case constitute the quintessential tax avoidance situation for post-income tax agreements and this Court treated it as such: "There is no doubt that the statute could tax salaries to those who earned them and provide that the tax *could not be escaped* by anticipatory arrangements and contracts however skilfully devised *to prevent* the salary when paid from vesting even for a second in the man who earned it." 281 U.S. at 114 (emphasis added). In addition, the failure to rescind the agreement after the imposition of the income tax must have been motivated in whole or in part by tax avoidance.

The assignment of income doctrine developed as, and is universally understood to be, a judicial doctrine crafted for the purpose of preventing taxpayers from planning ploys designed to defeat the progressive tax system. *See* Daniel Q. Posin, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 5.02 (5th ed., West 2000); *see also Lehman v. Commissioner*, 25 T.C. 629, 633 (1955) ("The anticipatory assignment of income doctrine *presupposes* the ability of the assignor to earn the income at issue and *an intent to escape the tax burden thereon* by transferring

the right to such income prior to its actual receipt.") (emphasis added).

This Court, in a very early assignment of income case, *Blair v. Commissioner*, 300 U.S. 5 (1937), expressly considered whether a tax avoidance purpose was afoot in determining not to apply the assignment of income doctrine. In that case, this Court ruled that the assignment by a father to his children of fixed annual dollar amounts of income to be paid from the life interest in a trust was effective for tax purposes. In so ruling, this Court noted that "[t]here is here no question of evasion or of giving effect to statutory provisions designed to forestall evasion." *Id.* at 12. In addition, this Court has explained further in another case, many years later, that:

> The principle of *Lucas v. Earl*, that he who earns income may not *avoid taxation* through anticipatory arrangements *no matter how clever or subtle*, has been repeatedly invoked by this Court and stands today as a cornerstone of our graduated income tax system.

Basye, supra, 410 U.S. at 450 (emphasis added).

The Commissioner's assertion that the presence or absence of a tax avoidance purpose is not relevant is also inconsistent with his position taken in a recent private letter ruling. Priv. Ltr. Rul. 200427009 (July 2, 2004)

(available at 2004 PRL LEXIS 342).[8] There, the Commissioner, citing, *inter alia*, *Cold Metal Process Co. v. Commissioner*, 247 F.2d 864 (6th Cir. 1957), and *Jones v. Commissioner*, 306 F.2d 292 (5th Cir. 1962), determined that where a taxpayer transfers a portion of a claim in litigation to a third party prior to the expiration of appeals, the taxpayer is "not required to include the proceeds of the judgment in income under the assignment of income doctrine." 2004 PRL LEXIS 342, at *11. The Commissioner based his ruling in part on the fact that the taxpayer's assignments in question "appear[ed] to have been motivated by genuine business purposes." 2004 PRL LEXIS 342, at **10, 12 (citing *Jones*, *supra*). The facts here are slightly different, but the principles cited by the Commissioner have general applicability. As the Commissioner recognized in his own ruling, the taxpayer's motivation is a significant factor in determining whether a transfer is an assignment of income. His position to the contrary in this case is incorrect.

[8] The private letter ruling is cited for the limited purpose of demonstrating the Commissioner's inconsistent position, not as precedent. *See* 26 U.S.C. § 6110(k)(3); *see also Hanover Bank v. Commissioner*, 369 U.S. 672, 686 (1962) (stating "[A]lthough the petitioners are not entitled to rely upon unpublished private rulings which were not issued specifically to them, such rulings do reveal the interpretation put upon the statute by the agency charged with the responsibility of administering the revenue laws."); *see also Harco Holdings, Inc. v. United States*, 977 F.2d 1027, 1035 n.13 (7th Cir. 1992) (citing private letter ruling as evidence of erroneous or inconsistent IRS position). In addition, the private letter ruling is a valuable resource to the extent of the strength of Commissioner's analysis therein and the cases relied on by the Commissioner.

C. The Assignment Of Income Doctrine Does Not Apply To Claims In Litigation That Are Speculative At The Time Of Transfer.

The Commissioner asserts that under the assignment of income doctrine "the contingent nature of the [attorney's] fee provides no basis for an exclusion from gross income." Pet. Br. 27. However, in the recent private letter ruling discussed above, the Commissioner directly contradicts his contention in this litigation that "any assignment" (Pet. Br. 27) of a claim in litigation is "necessarily" (*id.*) an assignment of income subjecting the assignor to tax, notwithstanding that the value of the claim is speculative and uncertain at the time of transfer. In that ruling, which addresses the transfer of claims in litigation, the Commissioner, citing, *inter alia*, *Cold Metal Process*, *supra*, and *Jones*, *supra*, stated that:

> [I]n general, a transferor who makes an effective transfer of a claim in litigation to a third person prior to the time of the expiration of appeals in the case is *not* required to include the proceeds of the judgment in income under the assignment of income doctrine because such claims are contingent and doubtful in nature.

Priv. Ltr. Rul. 200427009 (July 2, 2004) (available at 2004 PRL LEXIS 342, at *11) (emphasis added).[9]

In that ruling, a personal injury defendant entered into a contract with the plaintiff to assign to the plaintiff a portion of the defendant's bad faith claims against the defendant's insurer. In return, the personal injury plaintiff agreed to forego his judicial remedies against the defendant. The Commissioner concluded that the transferor was not required to include in income the

[9] Regarding the propriety of citing a private letter ruling, *see* footnote 8, *supra*.

portion of the recovery assigned to the personal injury plaintiff. His analysis in that ruling directly contradicts his argument in the instant litigation. The Commissioner, relying, *inter alia*, on *Earl*, stated that:

> In general, under the anticipatory assignment of income doctrine, a taxpayer who earns or otherwise creates a right to receive income will be taxed on any gain realized from it, if the taxpayer has the right to receive the income or if, based on the realities and substance of the events, the receipt of the income is *practically certain* to occur (*i.e.*, whether the right basically had become a fixed right), even if the taxpayer transfers the right before receiving the income. *Lucas v. Earl*, 281 U.S. 111, 114-115 (1930) [other citations omitted]. *In contrast, a mere anticipation or expectation of the receipt of income is insufficient to conclude that a fixed right to income exists.*
>
> With respect to the assignment of claims in litigation, a review of the case law shows that anticipatory assignment of income principles require the transferee to include the proceeds of the claim in gross income where recovery on the transferred claim is certain at the time of transfer, *but not where recovery on such claim is doubtful or contingent at the time of transfer.*

2004 PRL LEXIS, at **6-7 (emphasis added).

The Commissioner's private letter ruling is consistent with the Fifth Circuit's reasoning in *Cotnam* that the assignment of income doctrine does not apply where the existence and value of the claim assigned is speculative and unaccrued at the time of transfer. As the Fifth Circuit explained:

> [Plaintiff's] claim had no fair market value, and it was doubtful and uncertain as to whether it had any value. The only economic benefit she could then derive from her claim was to use a part of it in helping her to collect the remainder. Accordingly she, in effect, assigned to her attorneys forty per cent of the claim in order that she might collect the remaining sixty per cent. That was not the assignment of income of Mrs. Cotnam within the doctrine of *Lucas v. Earl*. * * * [S]he had earned a claim which was worthless without the aid of skillful attorneys. At the time that she entered into the contingent fee contract, she had realized no income from the claim, and the only use she could make of it was to transfer a part so that she might have some hope of ultimately enjoying the remainder.

Cotnam, 263 F.2d at 125.

If one applies the rationale of the Commissioner's ruling to the facts here, it is plain that the Sixth Circuit's decision below should be affirmed. In addition, the cases the Commissioner cites in his ruling also support the decision below. *See, e.g., Jones*, 306 F.2d at 301 (holding that where claim at time of assignment was "uncertain, doubtful and contingent," the transferor had no income upon the subsequent recovery on the claim under the assignment of income doctrine) (cited by Commissioner in 2004 PRL 342, at **9-10); and *Cold Metal Process*, 247 F.2d at 871-73 (holding that a taxpayer's right to receive income on a judgment does not vest for purposes of the assignment of income doctrine until all appeals have exhausted) (cited by Commissioner in 2004 PRL 342, at *8).

The taxpayer in the private letter ruling discussed above agreed to transfer to third parties two-thirds of any recovery in his bad faith insurance claim. 2004 PRL 342,

at **3-4. In this case, Mr. Banks ceded the contingent fee portion of his claim, but retained some of his general rights as a plaintiff, principally the right to settle or demand a nonsuit. *See Isrin v. Super. Ct.*, 403 P.2d 728, 732, 733 (Cal. 1965). This slight factual distinction, however, is not significant for purposes of the assignment of income doctrine. As explained above, by assigning a portion of a speculative claim to his attorney as a contingent fee in exchange for his attorney's indispensable services, Mr. Banks, like the bad faith claimant in the Commissioner's private letter ruling, relinquished all ability to receive or control disposition of that portion of any potential recovery. Pet. 24a; *Estate of Clarks*, 202 F.3d at 857; *Cotnam*, 263 F.2d at 125-26.

D. Mr. Banks And His Attorney Never Entered Into A Debtor-Creditor Relationship; Therefore, *Old Colony Trust* Is Not Relevant To This Case.

The Commissioner repeatedly cites (Pet. Br. 11, 19, 30, and 34) *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729 (1929), for the proposition that "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." The Commissioner's reliance on *Old Colony Trust*, however, is misplaced because it is based on the false premise that a contingent fee plaintiff has a "debt" to his or her attorney.

In *Old Colony Trust*, the taxpayer's employer paid the income tax liability on the taxpayer's salary directly to the Government. This Court held that the payment constituted income to the employee for services rendered notwithstanding that the taxpayer did not receive the money directly. This was a sensible decision given that this arrangement was the same in substance as a payment by the employer directly to the taxpayer,

followed by a payment by the taxpayer directly to the Government.

The Fifth Circuit in *Cotnam*, *supra*, correctly concluded that *Old Colony Trust* has no application to an attorney contingent fee agreement. 263 F.2d at 126. The Fifth Circuit's analysis in *Cotnam* follows the analysis above. The *Cotnam* court held that *Old Colony Trust* was inapposite because, at root, a contingent fee plaintiff has no "debt" to his or her attorney that is "discharged" by the defendant. Rather, the contingent fee plaintiff had, in effect, transferred to his attorney a portion of the lawsuit in return for the attorney's promise to render the services necessary to reduce the plaintiff's claims to recovery. *Id.* That a contingent fee plaintiff does not owe a "debt" to his attorney is confirmed by the fact that, absent a judgment or settlement, the attorney receives *nothing*.

E. A Determination That The Contingent Fee Was Income To Mr. Banks As Well As His Attorney Violates This Court's Longstanding Admonitions That Double Taxation Is To Be Avoided Absent A Clear Expression Of Congressional Intent To The Contrary.

The Commissioner asserts as illegitimate the court of appeals' concern that double taxation would result where the assignment of income doctrine is applied to a contingent fee agreement. "This purported 'double taxation,'" the Commissioner contends, "is neither anomalous nor harsh, but instead is a commonplace result inherent in the very nature of an income tax." Pet. Br. 34.

The Commissioner is mistaken. The court of appeals' concern is well-founded. As that court explained in *Estate of Clarks*, *supra*, one of the plain purposes of the judicial

assignment of income doctrine in *Earl* and *Horst* was to thwart a taxpayer's efforts to defeat the progressive marginal rate tax structure by diverting income to a family member in a lower tax bracket. 202 F.3d at 857. Even though application of the assignment of income doctrine bars such a maneuver, the income nevertheless is taxed only *once*. However, applying the assignment of income doctrine to a contingent fee contract results in taxing *both* the client *and* the attorney on the same funds, received at the same time, and in the same transaction:

> In [*Earl*] and *Horst*, the assignees were the object of gifts and not subject to income taxation themselves if the income was taxed to their assignor or donor. The IRS chose to tax the assignors, not both the donors and donees. By having the income taxed to the donor, the donee escapes income taxation. Not so here. Here the lawyer is taxed on the full amount of the payment. Under the government's theory both the lawyer and the client are taxable.

Estate of Clarks, 202 F.3d at 857.

Contrary to the Commissioner's assertion, double taxation is *not* "inherent in the very nature of an income tax." Pet. Br. 34. This Court has long taught that double taxation will *not* be presumed absent a clear expression of congressional intent to the contrary. *United States v. Hemme*, 476 U.S. 558, 572 (1986) (holding that double taxation requires clear expression of Congressional intent); *United California Bank v. United States*, 439 U.S. 180, 194 n.14 (1978) (noting Congress' policy against double taxation), *Hellmich v. Hellman*, 276 U.S. 233, 238 (1928); *United States v. Supplee-Biddle Hardware Co.*, 265 U.S. 189, 196 (1924) (stating double taxation "is to be avoided unless required by express words"); *see also Neptune Mut. Ass'n v. United States*, 862 F.2d 1546, 1549 (Fed. Cir. 1988) (stating "Double taxation is never to be

presumed") (citing *Tennessee v. Whitworth*, 117 U.S. 129, 137 (1886)). The basis provisions of the Internal Revenue Code, 26 U.S.C. §§ 1011, 1012, and 1016, also operate to prevent the double taxation of the same item of income. *See generally*, Daniel Q. Posin, FEDERAL INCOME TAXATION OF INDIVIDUALS ¶ 4.03 (5th ed., West 2000).

By contrast, where Congress has sanctioned double taxation, such as the taxation of corporate dividends, it has done so explicitly. However, nothing in the Internal Revenue Code evinces a clear expression of congressional intent to tax both a client and his or her attorney over the contingent fee portion of a damages recovery. The absence of plain statutory language compelling double taxation in the context of a contingent fee agreement is why the Commissioner must base his position in this litigation entirely on the court-created assignment of income doctrine. It is also of note that in all of the classic assignment of income cases decided by this Court, such as *Earl* and *Horst*, the sole issue was *which* taxpayer was liable. In none of these cases did the Commissioner even contend that more than one taxpayer had to include the same funds in income.

The Commissioner attempts to support his contention that double taxation is "inherent in the very nature of an income tax" by way of anecdote. The Commissioner suggests that "when an individual uses a portion of his salary to pay for the services of a plumber, the same income is taxed to both the individual and the plumber." Pet. Br. 34. The use of this example, however, begs the question, and this example is disanalogous to the facts here. When an individual uses post-tax earnings to pay for the services of the plumber, there can be little controversy. The customer, presumably, has already *earned* and been taxed on the income used to pay for the services of the plumber, a nondeductible personal expense. The plumber, in turn, is taxed on the income he

earns in return for his separate services. In a contingent fee scenario, by contrast, it is the attorney and the attorney alone who earns the contingent fee portion of the recovery. Because the plaintiff does not *earn* the attorney's fees portion of any recovery, he is unlike the plumber's customer in the Commissioner's example, and thus should not be charged with the income earned, retained by, and already taxed to the attorney. *Cf. Estate of Clarks*, 202 F.3d at 858 ("The income should be charged to the one who earned it and received it [*i.e.*, the attorney], not as under the government's theory of the case, to one who neither received it nor earned it [*i.e.*, the taxpayer-client]").

F. The Relationship Between A Contingent Fee Plaintiff And His Attorney Is Fundamentally Different From The Relationship Between An Hourly Or Fixed Fee Client And His Attorney, And The Tax Consequences To The Client Need Not Be The Same.

As noted above, a contingent fee arrangement is substantially different from the more typical billing arrangements based on time or a fixed fee. Most importantly, the plaintiff never has control or power of disposition over the contingent fee portion of any recovery. Also, unlike a situation where an attorney bills a client for his time, no debtor-creditor relationship arises between a contingent fee client and his attorney.

The Commissioner, relying on the Seventh Circuit's analysis in *Kenseth v. Commissioner*, 259 F.3d 881, 883 (7th Cir. 2001), contends that a contingent fee plaintiff should be treated identically for tax purposes as an hourly or fixed fee plaintiff. Pet. Br. 24-25. This line of argument is undercut by economic reality. There is a fundamental difference for tax purposes between a contingent fee

arrangement and an hourly or fixed-fee arrangement. The attorney paid hourly or pursuant to a fixed fee gets paid *regardless* of recovery, and thus does not incur anything close to the same level of risk as a contingent fee arrangement. *See, generally*, Michael P. Coyne, Richard Mason, & John R. Mills, *Contingent Legal Fees on Settlements and Awards and the Calculation of Gross Income by Individuals for United States Federal Income Tax Purposes*, 2 J. OF LEGAL TAX RESEARCH 1, 6-7 (2004) (concluding that the Sixth Circuit's approach is "more enlightened and more in line with the true economic aspects" of a contingent fee agreement, and that the Seventh Circuit's reasoning in *Kenseth*, *supra*, "that there should be no difference between an attorney hired for an hourly rate, and one hired on a contingency agreement seems out of touch with economic reality"). Under a contingent fee arrangement, however, the attorney assumes a great risk: absent recovery, he will not get paid. Whether there is a recovery or not depends on his skill and effort. In addition, once the client enters into the contingent fee agreement, he loses all practical control over that portion of any potential recovery.

Thus, as explained by the Fifth Circuit in *Cotnam*, and the Sixth Circuit below and in *Estate of Clarks*, a contingent fee contract, in effect, is akin to a joint venture between the attorney and his client. *Cotnam*, 263 F.2d at 126; Pet. App. 24a-25a; *Estate of Clarks*, 202 F.3d at 857-58. As explained in Section II, *supra*, the economic substance underlying a contingent fee arrangement, unlike an hourly fee arrangement, has all of the essential elements of a joint venture. Accordingly, the client should not be taxed on that portion of the recovery.

CONCLUSION

The Commissioner in this case bases his position entirely on a court-made anti-abuse rule developed to prevent taxpayers from shifting income to family members. As explained above, that judicial construct, the assignment of income doctrine, does not apply to an attorney contingent fee contract. As Judge Chabot explained in his dissent in *Kenseth*, *supra*, which was joined by four other members of the Tax Court, the assignment of income doctrine should not be turned inside-out to become the source of anomalous, unjust, and absurd outcomes:

> The majority in the instant case tax to petitioners substantial funds that petitioners did not receive, were never entitled to receive, and never turned their backs on. They do so in the name of the assignment of income doctrine. The majority acknowledge that there may be injustice in so doing, and that the injustice may well be even greater in other real-life settings than in the instant case. They contend that precedents compel them to this result and that relief can come only from the hills (Psalm 121), or at least from Capitol Hill. But this Court has shown * * * that reexamination of the origins of the assignment of income doctrine can sharpen our understanding of the concepts and make more rational the application of that doctrine. * * * [W]hen experience and analysis show that we have departed from the origins that we once thought to be the foundations of those decisions, and *when it is our judicial interpretations and not the statute law that lead to results that increasingly seem to be unjust*, then we ought to reexamine the foundations of the doctrine.

114 T.C. at 420-21 (Chabot, J., dissenting, joined by Parr, Wells, Colvin, Beghe, JJ.) (emphasis added) (citations omitted).

Accordingly, the decision of the court of appeals should be affirmed.

Respectfully submitted.

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APPENDIX

APPENDIX

26 U.S.C. § 61. Gross income defined.

(a) General definition. Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;
(2) Gross income derived from business;
(3) Gains derived from dealings in property;
(4) Interest;
(5) Rents;
(6) Royalties;
(7) Dividends;
(8) Alimony and separate maintenance payments;
(9) Annuities;
(10) Income from life insurance and endowment contracts;
(11) Pensions;
(12) Income from discharge of indebtedness;
(13) Distributive share of partnership gross income;
(14) Income in respect of a decedent; and
(15) Income from an interest in an estate or trust.

42 U.S.C. § 1988. Proceedings in vindication of civil rights.

* * * *

(b) Attorney's fees. In any action or proceeding to enforce a provision of sections 1977, 1977A, 1978, 1979, 1980, and 1981 of the Revised Statutes [42 USCS §§ 1981-1983, 1985, 1986], title IX of Public Law 92-318 [20 USCS § 1681 *et seq.*], the Religious Freedom Restoration Act of 1993, the Religious Land Use and Institutionalized

Persons Act of 2000, title VI of the Civil Rights Act of 1964 [42 USCS § 2000d *et seq.*], or section 40302 of the Violence Against Women Act of 1994, the court, in its discretion, may allow the prevailing party, other than the United States, a reasonable attorney's fee as part of the costs, except that in any action brought against a judicial officer for an act or omission taken in such officer's judicial capacity such officer shall not be held liable for any costs, including attorney's fees, unless such action was clearly in excess of such officer's jurisdiction.

42 U.S.C. § 2000e-5. Enforcement provisions.

* * * *

(k) Attorney's fee, liability of Commission and United States for costs. In any action or proceeding under this title [42 USCS § 2000e *et seq.*] the court, in its discretion, may allow the prevailing party, other than the Commission or the United States, a reasonable attorney's fee (including expert fees) as part of the costs, and the Commission and the United States shall be liable for costs the same as a private person.

Cal. Gov't Code § 12965. Accusation by department; Right-to-sue notice; Civil action by or on behalf of aggrieved person; Transfer of proceedings to court in lieu of hearing.

* * * *

(b) * * * In actions brought under this section, the court, in its discretion, may award to the prevailing party reasonable attorney's fees and costs, including expert witness fees * * *.

Supreme Court, U.S.
FILED
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Nos. 03-892 and 03-907

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

JOHN W. BANKS, II

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

SIGITAS J. BANAITIS

ON WRITS OF CERTIORARI
TO THE UNITED STATES COURTS OF APPEALS
FOR THE SIXTH AND NINTH CIRCUITS

REPLY BRIEF FOR THE PETITIONER

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REPLY BRIEF FOR THE PETITIONER

Petitioner's opening brief demonstrated (Br. 14-25) that federal tax law requires respondents to include in their gross income the entire amount of their litigation proceeds, including the portion paid as fees to their attorneys. It is a fundamental rule of federal tax law that income is taxed to the person who earns it, even when it is paid at that person's direction to someone else. *Lucas* v. *Earl*, 281 U.S. 111, 114-115 (1930). It is similarly well settled that, when a debt owed by a taxpayer is satisfied by a direct payment from a third party to the taxpayer's creditor, the taxpayer receives "income" in the amount of the discharged debt. *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716, 729 (1929). Thus, as the Court explained in *Helvering* v. *Horst*, 311 U.S. 112, 116-117 (1940), "he, who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants." Accordingly, where a taxpayer assigns to another "an obligation to pay compensation" to the taxpayer, he has "divert[ed] the payment from himself to others as the means of procuring the satisfaction of his wants" and is subject to tax on the diverted proceeds. *Id.* at 117, 118. Those federal tax law principles require the inclusion of the full amount of litigation proceeds in respondents' gross income.

A. Federal Tax Law Makes Clear That Respondents Earned All Of The Income Recovered On Their Causes Of Action

Respondents, and respondents alone, suffered the injuries that gave rise to their causes of action; they were the sole owners of their causes of action; and they had the sole right to assert and settle their claims. Their injuries gave rise to claims for recoveries in the form of taxable income, and the settlement proceeds represent the value given as compensa-

tion for those injuries and in exchange for the dismissal of their claims. Respondents therefore owned, controlled, and were "the source of the income" at issue. *Horst*, 311 U.S. at 116.

This would all be undisputed if the attorneys had charged an hourly fee, and nothing in the Internal Revenue Code authorizes radically more favorable tax treatment for those who opt for contingent-fee arrangements. Through their contingent-fee agreements, respondents "divert[ed] the payment [of a portion of that income] from [themselves] to others as the means of procuring the satisfaction of [their] wants," namely legal services. *Horst*, 311 U.S. at 117. Accordingly, the proceeds from respondents' litigation awards are "recover[ies] of lost income; the attorney fees [they] paid represent expenses incurred in generating that income"; and "[l]ike any other taxpayer, [respondents] must report the entire amount as gross income." *Hukkanen-Campbell* v. *Commissioner*, 274 F.3d 1312, 1314 (10th Cir. 2001), cert. denied, 535 U.S. 1056 (2002); accord *Raymond* v. *United States*, 355 F.3d 107 (2d Cir. 2004), petition for cert. pending, No. 03-1415 (filed Apr. 9, 2004); *Young* v. *Commissioner*, 240 F.3d 369 (4th Cir. 2001); *Baylin* v. *United States*, 43 F.3d 1451 (Fed. Cir. 1995).

Respondents and their amici raise a number of arguments in an attempt to evade these controlling principles of federal tax law. All of those arguments are unavailing for the reasons described below and in petitioner's opening brief (Br. 26-35).

1. Respondents' attorneys were not co-owners, partners, or joint venturers in respondents' causes of action

A central theme running through the briefs of respondents and their amici is that the relationship between client and attorney under a standard contingent-fee agreement is that of partners or joint venturers wherein the client contributes the capital (in the form of his cause of action) and the attorney contributes his professional services. According to

this theory, the amounts recovered on respondents' causes of action represented the proceeds from that partnership and are jointly owned by respondents and their attorneys. But the basic premise of that argument is patently erroneous.[1]

"A profit-oriented business arrangement is not a partnership unless two or more of the participants have an interest in the partnership *as proprietors*." 1 William S. McKee et al., *Federal Taxation of Partnerships and Partners* ¶ 3.02[5], at 3-15 (3d ed. 1997) (emphasis added) (citations omitted). The relationship of attorney and client, however, is one of agent and principal, not co-proprietorship. As stated in the Restatement (Third) of the Law Governing Lawyers, ch. 2 introductory note (2000), the client-lawyer relationship is "a voluntary arrangement in which an agent, a lawyer, agrees to work for the benefit of a principal, a client. A lawyer is an agent." See *Ferri* v. *Ackerman*, 444 U.S. 193, 204 (1979) (an attorney's "principal responsibility is to serve the undivided interests of his client"); *NAACP* v. *Button*, 371 U.S. 415, 460-461 (1963) ("[t]he relation of attorney and client is that of master and servant in a limited and dignified sense") (citation omitted). Moreover, while lawyers, as agents, owe a fiduciary duty to act in the best interests of their clients, clients owe no such reciprocal duty to their lawyers. See Restatement (Third) of the Law Governing Lawyers, ch. 2, § 17 & cmt. a (describing clients' duties to lawyer as "less extensive" and principally contractual and related to the payment of fees).

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[1] Respondent Banaitis goes so far as to argue—for the first time—that "[t]his case is governed by Subchapter K of the Internal Revenue Code," (Br. 1), which governs taxation of partnership profits. Banaitis never raised that argument below or in his brief in opposition, and it is therefore waived. Indeed, neither Banaitis in his lower court briefs nor the Ninth Circuit in its opinion ever cited to a single provision of Subchapter K. His sole argument, adopted by the court of appeals, was that Oregon's attorney lien statute "vests attorneys with property interests" that justify treating the contingent-fee portion of litigation proceeds as belonging to the attorney for tax purposes. Banaitis Pet. App. 16a; see Banaitis Br. in Opp. 7 ("[T]his is essentially a state law case.").

These authorities confirm that the relationship of attorney and client, under a contingent-fee agreement or otherwise, is one of principal and agent. It is not and cannot be a joint business undertaking. Indeed, Rule 5.4(b) of the Model Rules of Professional Conduct provides that "[a] lawyer shall not form a partnership with a nonlawyer if any of the activities of the partnership consist of the practice of law." Both California and Oregon have adopted this Rule. See Cal. R. Prof'l Conduct 1-310 (2004); Or. Code of Prof'l Responsibility DR 3-103 (2004).

Respondents ignore these authorities in baldly proclaiming that a contingent-fee agreement renders a client and his attorney partners or joint venturers. They cannot even point to any language in their respective contingent-fee agreements that purports to establish such a relationship. See J.A. 94-97, 99-105. Nor is there anything in the provisions of the applicable state law that supports respondents' anomalous position that their relationship with their attorneys was that of partners or joint venturers.

Respondent Banks's contingent-fee agreement is governed by California law. In *Benci-Woodward* v. *Commissioner*, 219 F.3d 941 (2000), cert. denied, 531 U.S. 1112 (2001), the Ninth Circuit examined the respective rights of attorneys and their clients under a contingent-fee agreement and held that California law "does not confer any ownership interest upon attorneys or grant attorneys any right and power over the suits, judgments, or decrees of their clients." *Id.* at 943. Indeed, the Supreme Court of California has made clear that, "in whatever terms one characterizes an attorney's lien under a contingent fee contract, it is no more than a *security* interest in the *proceeds* of the litigation," and "do[es] not operate to transfer a part of the cause of action to the attorney." *Isrin* v. *Superior Court*, 403 P.2d 728, 732 (1965) (citation omitted). It is thus apparent that respondent Banks and his attorney were not partners or joint venturers, but rather that their relationship at the time the attorney's

fees were paid was that of principal-agent and debtor-creditor.

Similarly, Oregon law, which governs respondent Banaitis's contingent-fee agreement, does not confer on the attorney any ownership interest in his client's cause of action or otherwise give the attorney control over the action. Rather, like most States, Oregon grants an attorney a lien on the litigation and its proceeds to secure payment of his fees. Or. Rev. Stat. § 87.445 (2003). Banaitis's assertion (Br. 33-36) that Oregon's attorney lien statute somehow precludes a party from settling or otherwise resolving his case without his attorney's consent is mistaken. See *Adams* v. *Transamerica Ins. Group*, 609 P.2d 834, 837 (Or. Ct. App. 1980) ("[A]n attorney has no interest in a settlement agreement independent of that of his client. If the attorney is entitled to attorney's fees he may maintain an action against his client for those fees. However, he does not have standing to maintain this suit" challenging the settlement.) (footnote omitted); *Smith* v. *United States Nat'l Bank*, 615 P.2d 1119, 1123 (Or. Ct. App. 1980) ("Even where an attorney has an interest in litigation, such as a contingent fee contract, * * * the client is under no duty to appeal an adverse trial court judgment.").

As with California's and most other States' attorney lien statutes, moreover, Oregon's statute draws no distinction between fees due under an hourly-fee arrangement and those due under a contingent-fee agreement; both types of attorneys receive the same lien. Accordingly, Oregon's attorney lien statute can provide no basis for treating contingent-fee lawyers, but not hourly-rate lawyers, as partners or co-owners in their clients' causes of action, a result that would also run afoul of Oregon's code of ethics. Or. Code of Prof'l Responsibility DR 3-103. Moreover, the concepts of lienholder and property owner are mutually exclusive, since a property owner cannot have a lien on his own property. See *Black's Law Dictionary* 933 (7th ed. 1999) (defining

"lien" as "[a] legal right or interest that a creditor has *in another's property*") (emphasis added).

Banaitis's reliance (Br. 33) on the decision in *Potter* v. *Schlesser Co.*, 63 P.3d 1172 (Or. 2003), is misplaced, because *Potter* does not purport to hold that a contingent-fee attorney acquires a partnership or joint venture interest in the client's cause of action. Rather, in *Potter*, the Oregon Supreme Court held that the term "lien" in Oregon Revised Statute Section 87.445 is to be given "its ordinary meaning," namely a "charge upon real or personal property for the satisfaction of some debt or duty ordinarily arising by operation of law." 63 P.3d at 1174 (citation omitted). The court went on to hold that the statutory attorney's lien attaches not just to the proceeds of a lawsuit, but to the lawsuit itself. Thus, the attorney in *Potter*, the Court held, could enforce the lien against the defendant, although the defendant had paid the entire amount of the judgment to the plaintiff, who failed to pay the attorney. *Potter* thus stands for no more than the proposition that an attorney in Oregon can recover his fee—hourly or contingent—from a third party who, in contravention of the attorney's lien, pays the entire amount of a judgment or settlement to the attorney's client. That holding preserves an Oregon attorney's rights as a secured *creditor*; it in no way lends support to Banaitis's claim that his attorney was not his creditor, but instead, was his partner or coventurer.

2. The attorneys were not the "true earners" of the litigation proceeds

Equally without merit is the related theory advanced by respondents and many of the amici that respondents' attorneys were the true "earners" of the contingent-fee portion of the recoveries by virtue of the provision of their legal services, and thus that only the attorneys realized income from those recoveries. See, *e.g.*, Banks Br. 4, 6-7; Banaitis Br. 23-24. Respondents' argument does not withstand analysis.

First, respondents ignore the fact that the legal right to recover damages arises at the time of the actionable *injury*, not when that right is subsequently reduced to judgment with (or without) the assistance of an attorney. Under the law, a plaintiff's right to income is complete when an actionable injury is suffered, because it is the injury that gives rise to the cause of action and provides the measure of the damages recovery to which the plaintiff is entitled. To be sure, an attorney's services may help enforce that income entitlement, but the attorney does not *earn* the damages award; the plaintiff had already "earned" his or her entitlement to that award by suffering injury before the attorney even appeared on the scene. What the attorney "earns" is merely the right to be paid for services rendered.

Second, the factual premise of respondents' argument—that they could not have recovered on their causes of action absent the services of their attorneys—is pure speculation. Many litigants successfully represent themselves, and there is no basis to determine from the record in these cases whether respondents could have achieved the same or similar recoveries had they represented themselves.

Third, and most importantly, even assuming that respondents would not have been able to obtain their recoveries without their attorneys' services, that would not render the contingent-fee portion of their recoveries excludable from their gross income. If respondents had desperately needed attorneys to bring their claims and had employed those attorneys on an hourly-fee basis and then used a portion of their recoveries to pay the fees, it would be undisputed that the *full* amount of the recovery would be taxable income. See *Kenseth* v. *Commissioner*, 259 F.3d 881, 883 (7th Cir. 2001). The extent to which respondents' recoveries were dependent on the skills of their attorneys, therefore, provides no basis for the exclusion from income sought by respondents.

Indeed, there are numerous situations in which portions of a taxpayer's income are attributable to the skilled services of

an agent or assistant employed by the taxpayer. Actors and professional athletes, for example, customarily employ skilled agents to negotiate contracts for them and pay those agents a percentage of the contract amount as a commission. Construction companies employ skilled sub-contractors who are entitled to be paid out of the proceeds of the construction project, a right secured by statutory liens on the project. Many companies use commissioned sales staff to sell their products, and many individuals turn over control of their financial assets to investment advisors whose compensation is a percentage of the value of the assets under their management or the investment income generated. Respondents' theory would mean that such taxpayers may exclude from their gross incomes the payments made to such agents, but there is no authority for that proposition, which would upset long-established principles of federal tax law. The Internal Revenue Code does not mandate more favorable treatment of those who contract for services—whether financial or legal advice—on a commission basis, rather than on an hourly-fee basis.

Thus, for example, a relatively unknown author who employs a leading literary agent for a ten percent commission to secure a publishing contract and who obtains a $1 million book contract largely because of the agent's efforts would realize gross income of $1 million. The $100,000 commission paid to the agent would be an expense of producing that income, just as if they had agreed to a non-contingent flat fee of $100,000 or an hourly rate that produced a $100,000 fee. In each case, that expense, to the extent permitted by the Internal Revenue Code, may be deducted in computing the author's taxable income. But the author could not seriously contend that he realized gross income of only $900,000, because the agent was the "true earner" of the portion of the contract proceeds ($100,000) paid in commission. See *Kenseth*, 259 F.3d at 883 ("If a taxpayer obtains income of $100 at a cost in generating that income of $25, he has gross income of $100 and a deduction of $25, * * * yielding

taxable income of $75 * * *. If, therefore, for some reason the cost of generating the income is not deductible, he has taxable income of $100."). Respondents' attorneys were, in essence, commissioned agents for respondents, and there is no logical reason why their commissions should receive different tax treatment than the commissions paid to other types of agents or more favorable treatment than attorneys paid hourly fees.

3. Respondents had sufficient control over the contingent-fee portion of the proceeds to warrant its inclusion in their gross income

Respondents also err in contending that they did not realize income from the proceeds paid directly to their attorneys because, under their contingent-fee agreements, they never had the right or ability to receive or control that income. As an initial matter, respondent Banks (Br. 11-12) overstates the degree of control necessary to warrant treating the contingent-fee portion of the recoveries as income to respondents. Relying, *inter alia*, on *Corliss* v. *Bowers*, 281 U.S. 376, 378 (1930), and *Commissioner* v. *Indianapolis Power & Light Co.*, 493 U.S. 203, 209 (1990), he asserts that the contingent-fee portion can only be treated as income to him if at all times he exercised "complete dominion" or "unfettered command" over that portion of his claim. But the cases on which he relies either did not involve a purported transfer or assignment of income at all, or refer to the degree of control necessary *before* the attempted transfer occurs. Respondents plainly exercised "complete" and "unfettered" control over their causes of action prior to the execution of the contingent-fee agreements. Indeed, the very fact that they promised to pay a percentage of any income they might receive as consideration for legal services conclusively demonstrates that they exercised such unfettered control and dominion.

It makes no sense to ask whether respondents continued to exercise complete or unfettered control over the contingent-fee portion of their income *after* they claim to have

transferred control over or otherwise to have assigned that portion to their attorneys. Rather, as explained in petitioner's opening brief (Br. 31-32), this Court's decision in *Commissioner* v. *Sunnen*, 333 U.S. 591 (1948), provides the framework for evaluating such claims. There, the Court stated, "[a]s long as the assignor actually earns the income or is otherwise the source of the right to receive and enjoy the income, he remains taxable," notwithstanding any attempted assignment or transfer. *Id.* at 604. Here, the "source of the right to receive and enjoy the income" was the *injury* suffered by respondents that gave rise to a cause of action under applicable law. Respondents are the sole source of that right, and are therefore taxable on the income it produced.

"The crucial question," the *Sunnen* Court further held, "remains whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes." 333 U.S. at 604; see *Horst*, 311 U.S. at 117-118 (where the taxpayer has "divert[ed] payment from himself to others as the means of procuring the satisfaction of his wants," he is taxable on the diverted proceeds). Here, respondents plainly retained "sufficient power and control" to warrant including the contingent-fee portion of the recovery in respondents' gross income.

A client who hires an attorney to prosecute a cause of action for him—whether on a contingent or an hourly-fee basis—retains ownership and control over his lawsuit. See *Chauffeurs, Teamsters & Helpers Local No. 391* v. *Terry*, 494 U.S. 558, 568-569 (1990) ("a client controls the significant decisions concerning his representation" and "can fire his attorney if he is dissatisfied with his attorney's performance"). Indeed, regardless of the fee arrangement, all attorneys have an overriding fiduciary duty to act only in the best interests of their clients. Thus, it was respondents, and not their attorneys, who at all times owned and controlled the disposition of their causes of action, and it was therefore

respondents who "earned" the entire amount of the litigation proceeds, including the portion that was paid as fees to their attorneys. As was the case with the father in *Helvering* v. *Horst*, *supra*, who gave up his right to the interest derived from his bond coupons but retained control of the bonds themselves, respondents, by retaining ultimate control of their causes of action, at all times "controlled the source of the income." *Raymond*, 355 F.3d at 116. "[They] could have fired [their] attorney[s]. [They] could have dropped [their] case[s]. [And they], and only [they], had the power to authorize a settlement of [their] claim[s]." *Ibid.*; accord *Kenseth*, 259 F.3d at 884. Because respondents controlled the source of the income, as a matter of federal tax law, the entire amount of litigation proceeds is includable in their gross income.[2]

4. The assignment-of-income doctrine is not limited to so-called "anti-abuse" situations or assignment of already-ascertained income

Banks argues (Br. 23) that the government's case rests not upon any provision of the Internal Revenue Code, but instead "relies exclusively upon a judicially-created anti-abuse rule known as the assignment of income doctrine." That is incorrect. The government's position rests ultimately on 26 U.S.C. 61, which provides that "[e]xcept as otherwise provided in this subtitle, gross income means all income from whatever source derived." See Pet. Br. 15. It is Section 61 that mandates inclusion of the entire proceeds of respondents' recoveries in their gross incomes. The

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[2] Respondent Banks's claim (Br. 17) that "[b]y entering into the contingent fee contract with his attorney, [he] ceded * * * *all* control over the portion attributable to the contingent fee earned and retained by his attorney" is particularly misplaced. Following the settlement, Banks refused to endorse the settlement check made out to him and his attorney until after his attorney agreed to receive $35,000 less than he was entitled to receive under the contingent-fee agreement. See J.A. 30-31, 36-37. Banks obviously did not relinquish all control over that income when he executed the agreement.

assignment-of-income doctrine, which is based on a long-standing construction of that statutory language, provides a complete answer to respondents' claim that the contingent-fee agreements operated to transfer or assign a portion of the proceeds of their causes of action to their attorneys, thereby diverting the incidence of tax.[3]

Respondents misstate both the intent and scope of the assignment-of-income doctrine. Banks characterizes it (Br. 23-24, 28) as solely an "anti-abuse" rule, and Banaitis similarly argues (Br. 23) that the assignment-of-income doctrine does not apply here because the contingent-fee agreement was "an arms-length transaction between unrelated parties in a commercial setting, for valuable consideration." As our opening brief explained (Br. 33), however, this Court has expressly rejected respondents' assumption that the assignment-of-income doctrine applies only to tax-motivated or bad faith transfers. In *Lucas* v. *Earl*, the Court expressly declined to consider the motives for the assignment of the taxpayer's income, stating that "no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew." 281 U.S. at 115. As the Second Circuit noted in *Raymond*, the *Earl* Court recognized that resting application of the assignment-of-income doctrine on the motives of the parties would be "to court procedural unmanageability" by placing the courts "in the position of having to divine the unknowable." 355 F.3d at 117. The fundamental rule of *Earl* is that income is to be taxed to the

[3] Nor is it true that the government's interpretation of Section 61 rests exclusively on the assignment-of-income doctrine. As demonstrated in Part B, *infra*, and in our opening brief (Br. 19, 30), the contingent-fee agreements at issue here gave rise to contingent debts running from respondents to their attorneys, and under the principle established in *Old Colony Trust*, *supra*, the direct payment by third parties to respondents' attorneys of the debts owed by respondents was income to respondents in the amount of the discharged debts, without regard to the applicability of the assignment-of-income doctrine.

person who earns it even where it is diverted in such a manner that it never vests in the taxpayer. It is of no moment why a taxpayer made an anticipatory assignment of his prospective income.[4]

Banaitis seeks to deflect the assignment-of-income doctrine by contending (Br. 24) that the income in *Earl* and *Horst* "had already been earned" or "was virtually certain to be earned." He urges that the assignment-of-income doctrine does not apply where the recovery is "an intangible, contingent expectancy." *Ibid.* (citation omitted). But the assignment-of-income doctrine is not so limited. Rather, as the Second Circuit pointed out in *Raymond*:

> [In *Earl*], the husband and wife agreed to co-own any future income each might earn. There existed no sum certain at the time of the agreement, and yet once the husband earned income and claimed that a portion of it had shifted to his wife, the Court found it to be an improper assignment of income. In both this case and *Earl*, the taxpayers assigned the right to receive a portion of as yet unascertained income to another.

355 F.3d at 116-117. The assignment-of-income doctrine thus does not rest on the certainty of the income assigned.

Banks (Br. 30-31) and Banaitis (Br. 25) argue that a private ruling issued by the IRS, P.L.R. 200427009 (Mar. 19, 2004), confirms that "motivation is a significant factor" in applying the assignment-of-income doctrine and that the doctrine generally does not apply to a transfer of a claim in litigation because "such claims are contingent and doubtful in nature." Private rulings are unofficial administrative interpretations issued by branch offices that "may not be used or cited as precedent," 26 U.S.C. 6110(k)(3), and are not representative of the published position of the IRS. In any

[4] Ironically, respondents' proposed construction of the statute would entail significant and unjustified tax advantages for contingent-fee arrangements over hourly- or flat-fee arrangements and would thereby create incentives for tax-motivated arrangements like those respondents contend gave rise to the assignment-of-income doctrine.

event, that ruling did not involve a purported assignment under a contingent-fee agreement and does not support respondents' arguments that lack of a tax-avoidance motive or uncertainty as to the amount of future income precludes application of the assignment-of-income doctrine. The IRS's official position that the portion of litigation proceeds used to pay attorney's fees is includable in the litigant's gross income is embodied in a Revenue Ruling, which (unlike the private letters cited by respondents) does represent the published position of the IRS on this question. See Rev. Rul. 80-364, 1980-2 C.B. 294, Situation 1 (where employee's damages award includes attorney's fee component, "the full amount of the award is income to the employee and must be included in the employee's gross income").

5. There is no proscription in the tax law against the purported "double taxation" at issue here

Banks (Br. 35-38) and Banaitis (Br. 30) both argue that the contingent-fee portion of their recoveries cannot be included in their gross income because that would result in "double taxation," *i.e.*, the same income would be taxed to two separate individuals. As petitioner's opening brief explains (Br. 34-35), there is no "double taxation" involved in these cases. The fact that the full award is taxable to the client and the fees are income to the attorney is neither anomalous nor harsh, but is instead a commonplace feature of the Internal Revenue Code. If, for example, a taxpayer hires an investment advisor and agrees to pay him a fee equal to a percentage of the investment income generated by the advisor, the full investment income is taxable to the investor and the percentage-based fee is taxable to the advisor. Moreover, the fees paid to the advisor would be a miscellaneous itemized deduction under 26 U.S.C. 67(b) and 212(1) and, as such, would not be allowable for purposes of the Alternative Minimum Tax (AMT). See 26 U.S.C. 56(b)(1)(A)(i). More broadly, whenever a taxpayer uses taxable income to purchase goods or services for which

Congress has either not allowed or limited a deduction, the original income will be taxed to the purchaser, and the seller will pay taxes on his income from the sale. But there is no "double taxation" in any meaningful sense.

Respondents' reliance on authorities holding that double taxation requires a clear expression of congressional intent is therefore misplaced. Those authorities concern true double taxation, *i.e.*, the taxation of the *same* income twice —not the taxation of two income events recognized by *different* taxpayers, although involving the same funds. See, *e.g.*, Banks Br. 35-38; Banaitis Br. 30. In any event, even if a clear expression of congressional intent were required here, it would be provided by the AMT's clear prohibition of any deduction for miscellaneous itemized deductions. See 26 U.S.C. 56(b)(1)(A)(i).

B. The Contingent-Fee Portion Of The Proceeds Is Includable In Respondents' Gross Income Because It Satisfied Respondents' Debts To Their Attorneys

This Court established in *Old Colony Trust*, 279 U.S. at 729, the fundamental federal tax principle that when a debt owed by a taxpayer is satisfied by a direct payment from a third party to the taxpayer's creditor, the taxpayer receives "income" in the amount of the discharged debt. That principle independently compels reversal here. The fee agreements executed by respondents gave rise to a contingent debt owed by them to their attorneys, which became a fixed debt when respondents recovered on their causes of action.

Respondents (Banks Br. 34-35; Banaitis Br. 16-17) and some of their amici assert, however, that there was no debtor-creditor relationship between respondents and their attorneys. They rely on the fact that respondents' attorneys would not have been entitled to any payment if respondents had not recovered on their causes of action, and they assert that respondents had no personal liability for the amounts due their attorneys under the fee agreements. Those arguments are meritless. The critical question is the relationship

between respondents and their attorneys at the time the payments to the attorneys were made. At that time, respondents' contingent obligations had become fixed. That, after all, is the reason the payments were made: Respondents were required by the terms of their fee agreements to pay specified portions of their recoveries to their attorneys. If respondents had received and retained all of the proceeds without paying the fees owed their attorneys, respondents would have been personally liable in the amount of the unpaid fees. Thus, the direct payment to respondents' attorneys by third parties discharged respondents' debts to their attorneys, and respondents thereby realized income in the amount of the discharged debts. See *Old Colony Trust*, 279 U.S. at 729; *Hukkanen-Campbell*, 274 F.3d at 1313-1314; *Baylin*, 43 F.3d at 1454.

That the relationship between respondents and their attorneys was that of debtor-creditor is confirmed by the lien granted under state law to respondents' attorneys. A lien is defined as "[a] legal right or interest that a *creditor* has *in another's property*, lasting usu[ally] until a debt or duty that it secures is satisfied." *Black's Law Dictionary* 933 (7th ed. 1999) (emphases added). A lien thus is an interest in a debtor's property that is granted to his creditor as security for payment of the debt. See *Kenseth*, 259 F.3d at 883. If, as respondents and most of their amici assert, the contingent-fee agreements entered into by respondents gave rise to no indebtedness running between respondents and their attorneys, there would be no basis for the liens granted to the attorneys under state law.

It is undisputed that an amount owed by a client to his attorney under an hourly-fee arrangement is a debt running from the client to his attorney. Since the attorney lien statutes in both California and Oregon, as well as those in other States, provide precisely the same lien to attorneys paid under an hourly-fee arrangement and attorneys paid under a contingent-fee arrangement, there is no logical basis for respondents' conclusion that while hourly fees owed by a

client to his attorney constitute a debt of the client, fees owed by a client to his attorney under a contingent-fee agreement do not.

C. Any Inequity That May Result From The Application Of The AMT To Contingent Attorney's Fees Is Within The Sole Power Of Congress To Remedy

Banks argues (Br. 21) that the inclusion in gross income of the attorney's fee portion of a recovery leads to "harsh and absurd results," in that taxes and attorney's fees could conceivably consume all of a client's recovery. This argument is misconceived, because any such "harshness" is a product of application of the AMT in this context, which is mandated by the plain language of the statute. Respondents' legal expenses are deductible under 26 U.S.C. 212(1), as "ordinary and necessary expenses paid or incurred * * * for the production or collection of income." Expenses deductible under Section 212(1) are itemized deductions, see 26 U.S.C. 211, and are classified as "miscellaneous itemized deductions" by 26 U.S.C. 67(b). Section 56(b)(1)(A) expressly provides that, in computing the AMT, "[n]o deduction shall be allowed * * * for any miscellaneous itemized deduction." There is no valid basis for disregarding the plain language of these directly applicable statutory provisions. If the application of the AMT has the potential to lead to harsh results in some cases, it is a matter that only Congress has the power to remedy. See *Commissioner* v. *Asphalt Prods. Co.*, 482 U.S. 117, 121 (1987) ("[j]udicial perception that a particular result would be unreasonable may enter into the construction of ambiguous provisions, but cannot justify disregard of what Congress has plainly and intentionally provided"); *Alexander* v. *IRS*, 72 F.3d 938, 946-947 (1st Cir. 1995) (recognizing that, although application of AMT to legal fees may result in a seemingly unfair outcome, "there is [no] inequality of treatment as compared to similarly situated taxpayers [and] * * * [i]t is well established that equitable

arguments cannot overcome the plain meaning of the statute").

Congress, moreover, is aware of concerns over the potential application of the AMT to litigation proceeds. It is currently considering proposed legislation that would provide an above-the-line deduction under 26 U.S.C. 62 (2000 & Supp. I 2001)—*i.e.*, a deduction that would be allowed in computing the AMT—for "attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination." Jumpstart Our Business Strength (JOBS) Act, H.R. 4520, 108th Cong., 2d Sess. § 643 (2004). That proposed legislation has been passed by the Senate and referred to the conference committee. See *Bill Summary and Status for the 108th Congress* <http://thomas.loc.gov/cgi-bin/bdquery/z?d108: HR04520:@@@X>. This proposed legislation reflects the ability of Congress to address any perceived unfairness in particular types of litigation. Respondents, by contrast, ask the courts to alter the tax treatment of *all* contingent-fee awards without any basis in statutory text.

In addition, Banks states (Br. 18) that the statutory causes of action on which his lawsuit was based contained "fee-shifting" provisions, under which the court allegedly could have awarded attorney's fees separate from and in addition to damages compensating the plaintiff for injuries and losses suffered. Banaitis contends (Br. 42, 45) that the government is "apparently attempting" to tax attorney's fees paid under fee-shifting statutes. The fees here, however, were paid under contingent-fee agreements, not under fee-shifting statutes. There was no award of statutory attorney's fees, and the attorney's fees paid to respondents' counsel were a percentage of the settlement proceeds, as provided in the fee agreements, not a "reasonable" fee calculated under the "lodestar" approach applicable under fee-shifting statutes. See, *e.g.*, *Hensley* v. *Eckerhart*, 461 U.S. 424, 433 (1983). The question whether attorney's fees awarded under fee-shifting statutes are excludable from the

plaintiff's gross income is therefore not presented here, and the Court need not decide that issue to resolve these cases. Moreover, the legislation currently pending before Congress is narrowly focused on certain civil rights cases, which are also the cases in which most fee-shifting occurs, and so, if enacted, would largely resolve that issue, while leaving intact the general principle that all litigation proceeds, including those paid to an attorney, are includable in the litigant's gross income.

In any event, respondents' concerns are exaggerated, because they ignore important distinctions between statutory fee awards and contingent fees. To be sure, in the absence of an assignment, it is the prevailing plaintiff, and not the attorney, that owns the claim for fees under a fee-shifting statute. See, *e.g.*, *Evans* v. *Jeff D.*, 475 U.S. 717, 730-732 (1986). That the prevailing plaintiff owns and controls the claim for fees would support treating an award of attorney's fees under a fee-shifting statute as gross income to the plaintiff in some instances—for example, where the plaintiff retains all or part of the award and is not contractually obligated to transfer the award to his attorney, see *Blanchard* v. *Bergeron*, 489 U.S. 87, 95 (1989), or where the fees are paid directly to the attorney in satisfaction of a debt owed by the prevailing party, see *Sinyard* v. *Commissioner*, 268 F.3d 756, 759-760 (9th Cir. 2001), cert. denied, 536 U.S. 904 (2002). This Court indicated in *Jeff D.*, however, that a prevailing plaintiff may be free to assign his statutory claim for attorney's fees to his attorney, see 475 U.S. at 730-731 (noting Congress "did not prevent the party from waiving this eligibility [for attorney's fees] anymore than it legislated against assignment of this right to an attorney"), and such assignments are not uncommon. Once such an assignment has occurred, courts generally permit the lawyer to sue on his own behalf to recover his fees, without the participation or consent of the prevailing party, see, *e.g.*, *Carpa, Inc.* v. *Ward Foods, Inc.*, 536 F.2d 39, 52 (5th Cir. 1976); *Goodman* v. *Heublein, Inc.*, 682 F.2d 44, 47-48 (2d Cir. 1982). If such an

assignment is viewed as a transfer of the entirety of the attorney's fee claim to the lawyer, such that the prevailing party retains no meaningful interest in or control over the claim, then it may be possible to view any recovery on that claim as income only to the lawyer.

* * * * *

For the foregoing reasons, and for the reasons stated in our opening brief, the judgments of the courts of appeals should be reversed with respect to the issue of the tax treatment of contingent attorney's fees.

Respectfully submitted.

PAUL D. CLEMENT
Acting Solicitor General

SEPTEMBER 2004

(14) (19)

Nos. 03-892 and 03-907

OCT 22 2004

In The
Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

JOHN W. BANKS, II

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

SIGITAS J. BANAITIS

On Writs Of Certiorari To The United States Courts Of Appeals For The Sixth And Ninth Circuits

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JOINT SUPPLEMENTAL BRIEF FOR RESPONDENTS

Pursuant to Rule 25.5 of this Court, Respondents in the above-entitled cases, which have been consolidated for oral argument on November 1, 2004, submit the following joint supplemental brief. The purpose of this supplemental brief is to call to the Court's attention newly enacted legislation, which the president signed into law October 22, 2004. While the new legislation is not retroactive, it nevertheless will limit sharply the impact of any decision rendered by the Court in future cases involving substantially the same facts. There is thus a possibility that the Court may conclude, upon examination of the new legislation, that both cases should be dismissed on the ground that the writs of certiorari were improvidently granted.

On October 22, 2004, the president signed the *American Jobs Creation Act of 2004*. Section 703 of the Act, entitled Civil Rights Tax Relief, amends section 62(a) of the Internal Revenue Code by expressly permitting a taxpayer to subtract from his or her gross income, in arriving at adjusted gross income, the "attorneys fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination" as defined by the Act. Section 62(e) of the Internal Revenue Code, as amended by the Act, defines the term "unlawful discrimination" as an act that is unlawful under various enumerated federal, state, and local statutory provisions, as well as common law claims. Section 703 is reproduced in an Appendix to this Supplemental Brief.

Significantly, Internal Revenue Code section 62(a), as amended by the Act, includes as "unlawful discrimination"

acts which gave rise to the tax disputes in both Respondents Banks's and Banaitis's respective cases. Respondent Banks's underlying discrimination claims, which gave rise to his current tax dispute with Petitioner, were based on violations of: (1) Title VII of the Civil Rights Act of 1964, as amended, 42 U.S.C. section 2000e *et seq.*; and (2) 42 U.S.C. sections 1981 and 1983. No. 03-892, Pet. App. 1a-5a. Internal Revenue Code sections 62(e)(13) and (14), as amended by the Act, expressly include as "unlawful discrimination" acts which violate 42 U.S.C. section 2000e-2, 2000e-3, 2000e-16, and 42 U.S.C. sections 1981 and 1983. Moreover, Respondent Banaitis's underlying claims, which gave rise to his current tax dispute with Petitioner, were based on state common law claims for wrongful discharge and tortious interference with contract by his former employer. No. 03-907, Pet. App. 4a. Internal Revenue Code section 62(e)(18)(ii) expressly includes as "unlawful discrimination" "[a]ny provision of * * * State, or local law, or common law claims permitted under * * * State, or local law – regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of any employee."

The new legislation applies to attorneys fees paid after the date of enactment with respect to any settlement or judgment occurring after its enactment. The new legislation thus does not apply to Respondent Banks's or Banaitis's respective tax disputes with Petitioner. However, any decision of this Court will have little or no impact on future tax disputes involving substantially the same facts. Moreover, prudential considerations, including deference to the coordinate branches, may warrant a

determination that a decision as to the merits should not be reached in either of these cases. A decision on the merits in favor of Petitioner in either or both cases would lead to disparate tax consequences for federal and state discrimination claimants, depending on the date when judgment was rendered or settlement was reached with respect to their claims.

A final consideration which may warrant dismissal in each case on the ground that the writ of certiorari was improvidently granted is that Sen. Charles Grassley, the Chairman of the Senate Finance Committee, stated on the Floor of the Senate, shortly following passage of the Act by Congress, that the portion of the Act relevant to each of these cases was designed to *clarify* and not change existing law, and that judgments rendered or settlements reached prior to the effective date of the Act should be treated identically as judgments and settlements subject to the Act:

> Mr. BAUCUS. As I understand it, the case law with respect to the tax treatment of attorney's fees paid by those that receive settlements or judgments in connection with a claim of unfaithful discrimination, a False Claims Act, "Qui Tam," proceeding or similar actions is unclear and that its application was questionable as interpreted by the IRS. Further it was never the intent of Congress that the attorneys' fees portions of such recoveries should be included in taxable income whether for regular income or alternative minimum tax purposes.

> Is it the understanding of the chairman that it was the conferees' intention for Section 703 to clarify the proper interpretation of the prior law, and any settlements prior to the date of enactment should be treated in a manner consistent with such intent?
>
> Mr. GRASSLEY. The Senator is correct. The conferees are acting to make it clear that attorneys' fees and costs in these cases are not taxable income, especially where the plaintiff, or in the case of a Qui Tam proceeding, the relator, never actually receives the portion of the award paid to the attorneys. Despite differing opinions by certain jurisdictions and the IRS, it is my opinion that this is the correct interpretation of the law prior to enactment of Section 703 as it will be going forward. In adopting this provision, Congress is codifying the fair and equitable policy that the tax treatment of settlements or awards made after or prior to the effective date of this provision should be the same. The courts and IRS should not treat attorneys' fees and other costs as taxable income.
>
> * * *
>
> [I]t is my strong belief that the courts and the IRS should apply the guidelines of Section 703 not only after the date of enactment but also to settlements put in place prior to that time.

150 CONG. REC. S11036 (daily ed. October 10, 2004). A dismissal would thus be consistent with that legislative history, because both Banks and Banaitis prevailed below.

For the foregoing reasons, the late developments described above may warrant dismissal of both of the consolidated cases on the ground that the writs of certiorari were improvidently granted.

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OCTOBER 2004

APPENDIX

Citations: H.R. 4520;
American Jobs Creation Act of 2004

Date: Oct. 7, 2004

SECTION 1. SHORT TITLE; ETC.

(a) SHORT TITLE. – This Act may be cited as the "American Jobs Creation Act of 2004".

(b) AMENDMENT OF 1986 CODE. – Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

* * *

SEC. 703. CIVIL RIGHTS TAX RELIEF.

(a) DEDUCTION ALLOWED WHETHER OR NOT TAXPAYER ITEMIZES OTHER DEDUCTIONS. – Subsection (a) of section 62 (defining adjusted gross income) is amended by inserting after paragraph (18) the following new item:

"(19) COSTS INVOLVING DISCRIMINATION SUITS, ETC. – Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination (as defined in subsection (e)) or a claim of a violation of subchapter III of chapter 37 of title 31, United States Code or a claim made under section 1862(b)(3)(A) of the Social Security Act (42 U.S.C. 1395y(b)(3)(A)). The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of

a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim."

(b) UNLAWFUL DISCRIMINATION DEFINED. – Section 62 is amended by adding at the end the following new subsection:

"(e) UNLAWFUL DISCRIMINATION DEFINED. – For purposes of subsection (a)(19), the term 'unlawful discrimination' means an act that is unlawful under any of the following:

"(1) Section 302 of the Civil Rights Act of 1991 (2 U.S.C. 1202).

"(2) Section 201, 202, 203, 204, 205, 206, or 207 of the Congressional Accountability Act of 1995 (2 U.S.C. 1311, 1312, 1313, 1314, 1315, 1316, or 1317).

"(3) The National Labor Relations Act (29 U.S.C. 151 et seq.).

"(4) The Fair Labor Standards Act of 1938 (29 U.S.C. 201 et seq.).

"(5) Section 4 or 15 of the Age Discrimination in Employment Act of 1967 (29 U.S.C. 623 or 633a).

"(6) Section 501 or 504 of the Rehabilitation Act of 1973 (29 U.S.C. 791 or 794).

"(7) Section 510 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1140).

"(8) Title IX of the Education Amendments of 1972 (20 U.S.C. 1681 et seq.).

"(9) The Employee Polygraph Protection Act of 1988 (29 U.S.C. 2001 et seq.).

"(10) The Worker Adjustment and Retraining Notification Act (29 U.S.C. 2102 et seq.).

"(11) Section 105 of the Family and Medical Leave Act of 1993 (29 U.S.C. 2615).

"(12) Chapter 43 of title 38, United States Code (relating to employment and reemployment rights of members of the uniformed services).

"(13) Section 1977, 1979, or 1980 of the Revised Statutes (42 U.S.C. 1981, 1983, or 1985).

"(14) Section 703, 704, or 717 of the Civil Rights Act of 1964 (42 U.S.C. 2000e-2, 2000e-3, or 2000e-16).

"(15) Section 804, 805, 806, 808, or 818 of the Fair Housing Act (42 U.S.C. 3604, 3605, 3606, 3608, or 3617).

"(16) Section 102, 202, 302, or 503 of the Americans with Disabilities Act of 1990 (42 U.S.C. 12112, 12132, 12182, or 12203).

"(17) Any provision of Federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law.

"(18) Any provision of Federal, State, or local law, or common law claims permitted under Federal, State, or local law –

"(i) providing for the enforcement of civil rights, or

"(ii) regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.".

(c) EFFECTIVE DATE. – The amendments made by this section shall apply to fees and costs paid after the date of the enactment of this Act with respect to any judgment or settlement occurring after such date.

Nos. 03-892 and 03-907

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

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COMMISSIONER OF INTERNAL REVENUE, PETITIONER,

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SIGITAS J. BANAITIS

ON WRITS OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH AND NINTH CIRCUITS

SUPPLEMENTAL BRIEF FOR THE PETITIONER

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ON WRITS OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE SIXTH AND NINTH CIRCUITS

SUPPLEMENTAL BRIEF FOR THE PETITIONER

This supplemental brief is filed pursuant to Rule 25.5 of the Rules of this Court to bring to the attention of the Court legislation that was enacted after the briefs of the United States were filed in this case. Oral argument in these cases is scheduled for November 1, 2004.

After the government filed its reply brief, Congress enacted legislation relevant to these cases. That legislation neither moots this litigation nor eliminates the ongoing significance of the question presented. The legislation does, however, confirm the correctness of the Commissioner's treatment of the litigation awards at issue.

1. The government's reply brief (at 18) indicated that Congress was considering a bill that would provide an above-the-line deduction under 26 U.S.C. 62 (2000 & Supp. I 2001)—i.e., a deduction that would be allowed in computing the alternative minimum tax (AMT)—for attorney's fees and costs paid in connection with any action involving a claim of unlawful discrimination. That proposed legislation has now been enacted into law. On October 11, 2004, Congress passed the American Jobs Creation Act of 2004 (the Act), and the President signed the Act into law on October 22, 2004.

Section 703 of the Act (App., *infra*, 1a-3a) is entitled "Civil Rights Tax Relief." Section 703(a) amends Section 62(a) of the Internal Revenue Code to provide a deduction from gross income for, *inter alia*, "[a]ny deduction allowable under [chapter 1 of subtitle A of the Code] for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination." *Id.* at 1a.

Section 703(b) of the Act defines "unlawful discrimination," as that phrase is used in Section 703(a), to mean "an act that is unlawful" under any of a number of specifically identified federal civil rights and anti-discrimination laws, as well as any conduct that falls within either of two catch-all clauses. App., *infra*, 1a-2a. The first of those more general provisions (adding Section 62(e)(17)) includes within the definition of "unlawful discrimination" any conduct that violates any

federal "whistleblower protection" law, and the second (adding Section 62(e)(18)) encompasses "[a]ny provision of Federal, State, or local law, or common law claims * * * regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law." *Id.* at 3a.

Congress expressly provided that the Act would have purely prospective application. Section 703(c) specifies that the Act's amendments to Section 62(a) "shall apply to fees and costs paid after the date of the enactment of this Act with respect to any judgment or settlement occurring after such date." App., *infra*, 3a.

2. The newly enacted legislation, although relevant to the question presented in these cases, does not render these cases moot or eliminate the continuing importance of the question presented.

First, the legislation does not apply retroactively to respondents' claims. As explained above, Section 703 applies only to "fees and costs paid after the date of the enactment of this Act with respect to any judgment or settlement occurring after such date." App., *infra*, 3a. Thus, although Section 703 would permit a deduction for individuals who bring employment-related claims and pay fees and costs with respect to judgments or settlements occurring after October 22, 2004, the Act does not retroactively authorize any deduction for respondents.

Second, the question presented in these cases remains of continuing importance. The deduction allowed by Section 703 is limited to attorney's fees and costs in cases involving claims of "unlawful discrimination," as

defined in the Act. In contrast, the question presented —"[w]hether * * * a taxpayer's gross income from the proceeds of litigation includes the portion of his damages recovery that is paid to his attorneys pursuant to a contingent fee agreement" (Banks Pet. I)— potentially arises in any case in which the plaintiff retains a lawyer pursuant to a contingent-fee agreement. Contingent-fee arrangements are a routine feature of many types of litigation other than employment discrimination and civil rights cases. Section 703 thus does not affect the tax treatment of the contingent-fee portion of litigation proceeds in a wide array of cases, such as state tort law claims for defamation, intentional infliction of emotional distress, breach of contract, or unfair competition,[1] or federal claims for violation of the securities, antitrust, patent, trademark, or copyright statutes. The issue also arises in personal injury cases to the extent punitive damages or other damages not "on account of personal physical injuries or physical sickness" are awarded. 26 U.S.C. 104(a)(2) (2000 & Supp. I 2001); see Pet. Br. 15 n.3.

Moreover, nothing in the courts of appeals' decisions in these cases turned on the fact that the claims arose in the employment context. Accordingly, whether the contingent-fee portion of litigation proceeds are includable in the plaintiff's gross income under Section 61(a) of the Code is an issue that will continue to arise, and to do so frequently, notwithstanding Congress's enactment of Section 703. Many of the cases cited in

[1] Indeed, respondent Banks originally sued not only for alleged violations of federal anti-discrimination statutes, but also for defamation, intentional infliction of emotional distress, and tortious interference with business relations in violation of state law. See Pet. App. 2a-3a.

the petitions for certiorari in these cases, for example, involved claims that would not be covered by Section 703. See, *e.g.*, *Young* v. *Commissioner*, 240 F.3d 369 (4th Cir. 2001) (property dispute between former spouses); *Foster* v. *United States*, 249 F.3d 1275 (11th Cir. 2001) (fraud claim); *Srivastava* v. *Commissioner*, 220 F.3d 353 (5th Cir. 2000) (defamation claim); *Estate of Clarks* v. *United States*, 202 F.3d 854 (6th Cir. 2000) (personal injury claim); *Baylin* v. *United States*, 43 F.3d 1451 (Fed. Cir. 1995) (condemnation action); *Cotnam* v. *Commissioner*, 263 F.2d 119 (5th Cir. 1959) (will contestation action). The question presented in these cases therefore remains an issue of continuing importance for this Court to resolve.

3. Although Section 703 is not directly applicable here, its enactment provides additional support for the Commissioner's position in these cases. First, Section 703 confirms the Commissioner's position that gross income, as defined in Section 61(a) of the Code, includes the entire amount of a litigation recovery, including any part that is paid to an attorney under a contingent fee agreement. In enacting Section 703, Congress did not exclude any portion of litigation proceeds from gross income, as, for example, it did in Section 104(a) and (2) with respect to physical injury damages. See 26 U.S.C. 104(a) and (2) ("gross income does not include * * * the amount of any damages (other than punitive damages) received * * * on account of personal physical injuries or physical sickness"). Rather, Congress recognized that the entire amount of litigation proceeds constitutes gross income and provided an above-the-line *deduction* from gross income *for* certain litigation *expenses*, in-

cluding attorney's fees.[2] If respondents and the courts of appeals below were correct that the contingent fee portion of litigation proceeds is excluded from gross income altogether under Section 61(a), it would have made no sense for Congress to create a new above-the-line deduction under Section 62(a) for attorney's fees and costs associated with certain civil rights suits.[3]

---

[2] The Conference Committee's Joint Explanatory Statement accompanying the Act, although acknowledging the current circuit conflict over the treatment of contingent fees, confirms that "present law" generally takes this approach. It explains that with the exception of personal injury damages which are expressly excluded from a taxpayer's gross income:

> [o]ther damages are generally included in gross income. The related expenses to recover the damages, including attorneys' fees, are generally deductible as expenses for the production of income, subject to the two-percent floor on itemized deductions. Thus, such expenses are deductible only to the extent the taxpayer's total miscellaneous itemized deductions exceed two percent of adjusted gross income. Any amount allowable as a deduction is subject to reduction under the overall limitation of itemized deductions if the taxpayer's adjusted gross income exceeds a threshold amount. For purposes of the alternative minimum tax, no deduction is allowed for any miscellaneous itemized deduction.

H.R. Conf. Rep. No. 755, 108th Cong., 2d Sess. 471 (2004).

[3] Any attempt by respondents to rely on a floor statement by Senator Grassley, 150 Cong. Rec. S11,036 (daily ed. Oct. 10, 2004), to the effect that Section 703 was intended to "clarify" rather than change existing law would be misplaced. In that statement, Senator Grassley stated his opinion that Congress never intended to include "attorneys' fees and other costs" in a taxpayer's taxable income, and that Section 703 clarifies that fact. *Ibid.* As an initial matter, it is clear that Senator Grassley was referring to a prior version of the bill that would have given Section 703 at least partial retroactive application. The bill Congress *actually* passed, however, expressly provided for prospective application only. In any event, such individual statements are generally an inadequate indicator of congressional intent. See, *e.g.*, *Fidelity Financial Servs., Inc.* v. *Fink*, 522 U.S. 211, 220 (1998). That is particularly true here, where the relevant statutory language, Section 61(a)'s definition of "income," has been unchanged since the enactment of the 1954 Internal Revenue Code. See *South Dakota* v. *Yankton Sioux Tribe*, 522 U.S. 329, 355 (1998) (characterizing subsequent legislative history as "a hazardous basis" on which to infer congressional intent). Moreover, Section 703 obviously works a change in existing law, as reflected by Congress's decision to make the application of the Section prospective only. Like the new legislation itself, Senator Grassley's statement speaks generally to "attorneys' fees," and is not limited to contingent fees. Yet it is undisputed that prior to the enactment of Section 703, such fees paid on an hourly basis were included in a taxpayer's gross income without deduction under the AMT. It is therefore beyond dispute that Section 703 changed existing tax law, notwithstanding Senator Grassley's statement to the contrary.

Second, Section 703 illustrates Congress's ability to rectify any perceived unfairness arising from the application of the AMT to certain types of litigation proceeds. This narrowly tailored congressional resolution fully addresses the policy concerns raised by respondents and their amici about the tax effect on civil rights cases, and it does so without working any revolution in the definition of gross income or in the application of longstanding principles of federal tax law. Respondents and the courts of appeals below, by contrast, would distort federal tax law principles in order to alter the tax treatment of *all* contingent fee awards, without any basis in the statutory text.

Third, the new deduction created by Section 703 is not limited to contingent-fee payments, but instead encompasses all payments of attorney's fees without regard to the nature of the fee arrangement. Section 703 thus accomplishes its goals without creating any

disparity in the Code between the treatment of attorney's fees paid on an hourly basis and those paid on a contingent basis, thereby maintaining the Code's neutral treatment of contingent and hourly fees. The judicial exception advocated by respondents and adopted below, on the other hand, would make potentially dramatic tax consequences turn on the fortuity of whether the plaintiff's lawyer was retained on an hourly-rate, rather than a contingent-fee, basis. Nothing in the Code justifies such an anomalous preference for contingent-fee arrangements, as Section 703 again confirms. See Pet. Br. 24-25; *Kenseth* v. *Commissioner*, 259 F.3d 881, 883 (7th Cir. 2001) (Posner, J.) (explaining that, with respect to tax liability, it makes no difference "that the expense happened to be contingent rather than fixed").

* * * * *

For the foregoing reasons, and for the reasons stated in our opening and reply briefs, the judgments of the courts of appeals should be reversed with respect to the issue of the tax treatment of contingent attorney's fees.

Respectfully submitted.

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OCTOBER 2004

APPENDIX

SEC. 703. CIVIL RIGHTS TAX RELIEF.

(a) **Deduction Allowed Whether or Not Taxpayer Itemizes Other Deductions.**—Subsection (a) of section 62 (defining adjusted gross income) is amended by inserting after paragraph (18) the following new item:

> "(19) Costs involving discrimination suits, etc.-Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination (as defined in subsection (e)) or a claim of a violation of subchapter III of chapter 37 of title 31, United States Code or a claim made under section 1862(b)(3)(A) of the Social Security Act (42 U.S.C. 1395y(b)(3)(A)). The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim.".

(b) **Unlawful Discrimination Defined.**—Section 62 is amended by adding at the end the following new subsection:

> "(e) **Unlawful Discrimination Defined.**—For purposes of subsection (a)(19), the term 'unlawful discrimination' means an act that is unlawful under any of the following:

"(1) Section 302 of the Civil Rights Act of 1991 (2 U.S.C. 1202).

"(2) Section 201, 202, 203, 204, 205, 206, or 207 of the Congressional Accountability Act of 1995 (2 U.S.C. 1311, 1312, 1313, 1314, 1315, 1316, or 1317).

"(3) The National Labor Relations Act (29 U.S.C. 151 et seq.).

"(4) The Fair Labor Standards Act of 1938 (29 U.S.C. 201 et seq.).

"(5) Section 4 or 15 of the Age Discrimination in Employment Act of 1967 (29 U.S.C. 623 or 633a).

"(6) Section 501 or 504 of the Rehabilitation Act of 1973 (29 U.S.C. 791 or 794).

"(7) Section 510 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1140).

"(8) Title IX of the Education Amendments of 1972 (20 U.S.C. 1681 et seq.).

"(9) The Employee Polygraph Protection Act of 1988 (29 U.S.C. 2001 et seq.).

"(10) The Worker Adjustment and Retraining Notification Act (29 U.S.C. 2102 et seq.).

"(11) Section 105 of the Family and Medical Leave Act of 1993 (29 U.S.C. 2615).

"(12) Chapter 43 of title 38, United States Code (relating to employment and reemployment rights of members of the uniformed services).

"(13) Section 1977, 1979, or 1980 of the Revised Statutes (42 U.S.C. 1981, 1983, or 1985).

"(14) Section 703, 704, or 717 of the Civil Rights Act of 1964 (42 U.S.C. 2000e-2, 2000e-3, or 2000e-16).

"(15) Section 804, 805, 806, 808, or 818 of the Fair Housing Act (42 U.S.C. 3604, 3605, 3606, 3608, or 3617).

"(16) Section 102, 202, 302, or 503 of the Americans with Disabilities Act of 1990 (42 U.S.C. 12112, 12132, 12182, or 12203).

"(17) Any provision of Federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law.

"(18) Any provision of Federal, State, or local law, or common law claims permitted under Federal, State, or local law-

"(i) providing for the enforcement of civil rights, or

"(ii) regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law."

(c) **Effective Date**.—The amendments made by this section shall apply to fees and costs paid after the date of the enactment of this Act with respect to any judgment or settlement occurring after such date.

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SIGITAS J. BANAITIS, *Respondent*.

On Writs Of Certiorari to the United States Courts of Appeals for the Sixth and Ninth Circuits

AMICUS CURIAE BRIEF OF THE ASSOCIATION OF TRIAL LAWYERS OF AMERICA IN SUPPORT OF RESPONDENTS

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AMICUS CURIAE BRIEF OF THE ASSOCIATION OF TRIAL LAWYERS OF AMERICA IN SUPPORT OF RESPONDENTS

IDENTITY AND INTEREST OF *AMICUS CURIAE*

The Association of Trial Lawyers of America ["ATLA"] respectfully submits this brief as *amicus curiae*. The parties have filed letters of consent to the filing of this amicus brief with this Court.[1]

ATLA is a voluntary national bar association whose approximately 50,000 trial lawyer members primarily represent individual plaintiffs in civil actions.

[1] Pursuant to Rule 37.6, Amicus discloses that no counsel for a party authored any part of this brief, nor did any person or entity other than Amicus Curiae, its members, or its counsel make a monetary contribution to the preparation or submission of this brief.

ATLA is concerned that the tax treatment of attorney fees proposed by the Commissioner will result in unfair and excessive taxation of plaintiffs in nonphysical personal injury cases and will undermine the enforcement through private civil lawsuits of important personal rights guaranteed under both state and federal law.

SUMMARY OF THE ARGUMENT

1. The Commissioner asks this Court to approve the IRS treatment of attorney fees that are incurred by plaintiffs who receive damages in nonphysical personal injury cases. The Commissioner asserts that legal fees must be included in gross income and deducted as miscellaneous itemized deductions. Although a number of lower courts have agreed with the Commissioner, this include-deduct method results in unfair taxation and undermines substantive state and federal law.

Miscellaneous itemized deductions are not fully deductible, and, where the alternative minimum tax is triggered, are not deductible at all. As a result, plaintiffs are taxed on amounts they did not receive and over which they had no dominion or control. Although the cases before the Court involve contingency fees, the IRS has applied this treatment to court-awarded fees under fee-shifting statutes, which permit fees in excess of monetary awards. In some cases, a victim of discrimination who "won" in court has owed more in taxes than the net recovery.

This draconian result is not only unfair to the affected taxpayers; it also undermines the purposes of state and federal laws protecting personal rights. The prospect of excessive tax liability, even to the point of exceeding any recovery, is a powerful disincentive to seeking vindication of rights in court.

It undermines the legitimate interests of the States in enforcing their own tort laws, a result Congress did not intend. And it undermines the intent of Congress to rely on private lawsuits to eradicate discrimination and to assure legal representation to the victims of discrimination by authorizing court-awarded attorney fees.

The include-deduct method also undermines congressional purpose by making good faith settlement of such claims more complicated and expensive for plaintiffs and defendants alike.

2. The Commissioner does not base the include-deduct treatment of attorney fees on specific Code provisions, but on an interpretation of judge-made doctrines. It is clear that the assignment of income doctrine does not apply to contingency fee agreements. The doctrine preserves the graduated structure of the income tax by barring an assignment of income by the person who earned it to a lower bracket donee. It does not result in allocating the income to both.

Most importantly, the doctrine applies to taxpayers who retain an income-producing asset while redirecting the stream of income produced. In this case, the taxpayers' causes of action are not income-producing. They relinquished their claims entirely in exchange for money. The appropriate tax rules are those governing the disposition of property.

Nor is the payment of fees a repayment of a debt owed by the client to the attorney. Under a contingency fee agreement, no pre-existing debt exists. Moreover, court-awarded fees satisfy a debt owed by the defendant, not the client.

The include-deduct method is not required to avoid a tax incentive favoring contingency fee arrangements over hourly-rate payment. For compelling non-tax reasons, few individuals pay attorneys by the hour to pursue nonphysical personal injury claims. Plaintiffs cannot afford such hourly fees, as Congress itself recognized. Contingency fees also shift the risk of loss to the attorney, and align the attorney's interest with that of the client.

3. Damages received on account of personal injury constitute the proceeds of disposition of property. An unliquidated cause of action is a species of property. Under the Code, it is "intangible personal property" which can be bought, sold or assigned. In fact, taxpayer Banks in this case purchased his cause of action. A cause of action also qualifies as a capital asset under the Code. The taxpayer's release or relinquishment of a cause of action in exchange for a monetary award or settlement comes within the broad definition of a "disposition" of property. The proper treatment of legal fees is as a capital expense, subtracted from the proceeds of the settlement or award, not as a deduction.

This capitalization of legal fees does not offend the "origin of the claim" test, which governs deductions from income for legal fees related to income-producing assets. The test does not address the antecedent question of whether taxpayer has income in the first place. The test does not apply to the disposition of property, where the general rule is that legal fees are a capital expense. Subtracting attorney fees to arrive at gross income does not lead to lead to conversion of that income from ordinary to capital gain.

ARGUMENT

I. TAXATION OF ATTORNEY FEES AS INCOME TO CLIENTS IS UNFAIR AND UNDERMINES THE PURPOSES OF STATE AND FEDERAL LAWS.

A. Treatment of Attorney Fees Income To Both Client and Attorney Results in Unfair Double Taxation of Damages Received on Account of Nonphysical Injury.

Taxpayer Sigitas Banaitis, a bank vice president, brought suit against the bank and its new owner, alleging wrongful discharge, interfering with his employment agreement, and punishing him for refusing to disclose confidential information of the bank's customers. An Oregon state court jury agreed and awarded Banaitis compensatory and punitive damages. The court of appeals upheld the jury's verdict. *Banaitis v. Mitsubishi Bank, Ltd.*, 129 Or. App. 371, 879 P.2d 1288 (1994). The parties reached a settlement totaling $8,728,599. Of that amount, $3,864,012 was paid directly to Banaitis's attorneys, pursuant to their contingency fee agreement with Banaitis. *Banaitis v. Commissioner,* 340 F.3d 1074, 1077-78 (9th Cir. 2003).

Taxpayer John W. Banks, brought suit against his former employer, the California Department of Education, alleging he was fired in violation of Title VII, 42 U.S.C. § 1981, and 42 U.S.C. § 1983. During the trial, the parties settled. DOE paid $464,000 to Banks, who paid $150,000 to his attorney pursuant to their contingency fee agreement. *Banks v. Commissioner*, 345 F.3d 373, 375-76 (6th Cir. 2003).

In both instances the Commissioner issued a notice of deficiency, asserting that the taxpayers were required to include the amount paid to their attorneys in gross income. *Banaitis* at 1078; *Banks* at 382. As a result, taxpayers' liability was substantially increased. Their situation is hardly unique.

Prior to the mid-1990's, I.R.C. § 104(a)(2), which excluded from income "damages received . . . on account of personal injuries," was widely viewed as encompassing such nonphysical harms as employment discrimination. *See Commissioner v. Schleier*, 515 U.S. 323, 338-39 (1995) (O'Connor, J., dissenting). Even as this Court set forth a more restrictive reading of that section in *Schleier* and in *United States v. Burke,* 504 U.S. 229 (1992), the Court indicated that taxable damages in such cases excluded attorney fees. In *O'Gilvie v. United States,* 519 U.S. 79 (1996), the Court held that the "net proceeds" of plaintiffs punitive damages claims were not excluded under I.R.C. § 104(a)(2).[2] *See* 6 MERTENS LAW OF FEDERAL INCOME TAXATION § 24A:42.12 (Supp. 2001). *See also id.* at § 24A:42.12 n.24 (citing lower federal court opinions treating punitive damages, net of attorney fees, as taxable income).

Shortly thereafter, Congress amended the Code to exclude only damages received on account of "physical injuries." Small Job Protection Act of 1996, Pub. L. No. 104-188, § 1605(a), 110 Stat. 1755, 1838 (1996); I.R.C. § 104(a)(2) (1997). As a result, many

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[2] The lower court opinion makes clear that the "net proceeds" were net of attorney fees and expenses. See *O'Gilvie v. United States,* 66 F.3d 1550, 1552 (10th Cir. 1995).

types of tort or tort-like damages involving nonphysical harm under state and federal law were no longer excluded from income.

The IRS quickly took the position that plaintiff's income in such cases should also include fees paid to plaintiff's attorney under a contingent fee agreement. *See* Priv. Ltr. Rul. 98-09-053 (Dec. 2, 1997). Such fees, the IRS maintained, should be treated as miscellaneous itemized deductions under I.R.C. § 67(a). The Service has targeted such taxpayers for enforcement attention. *See generally*, Internal Revenue Service, *Market Segment Specialization Program Audit Guide for Lawsuit Awards and Settlements* (Doc. 2001-2574).

Taxpayers would not be significantly harmed if the included attorney fees were fully deductible. But they are not. I.R.C. § 67(a) sets a floor, permitting deductions "only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income." They are also subject to a phase out when adjusted gross income exceeds the applicable amount – $142,700 ($71,350 for a married individual filing separately) in 2004. I.R.C. §1, Note. The combined effect of these limitations is to increase the taxpayer's effective marginal tax rate significantly. Laura Sager and Stephen Cohen, *How the Income Tax Undermines Civil Rights Law,* 73 So. Cal. L. Rev. 1075, 1085 (2000).

Worse yet, the taxpayer may be denied any deduction at all for legal fees where the Alternative Minimum Tax is triggered. The AMT imposes rates of 26 or 28%, and "[n]o deduction shall be allowed for any miscellaneous itemized deduction." I.R.C. § 56(b)(1)(A)(i) (2000). As one Tax Court judge stated, applying the AMT in this situation "can raise

effective tax rates to hardship levels." *Kenseth v. Commissioner,* 114 T.C. 399, 419 (2000) (Chabot, J., dissenting). In fact, notes Judge Beghe, dissenting in the same case, where total legal fees exceed about 72% of gross recovery, the tax can exceed plaintiff's net recovery. *Id.* at 425-26 n. 17 (Beghe, J., dissenting). *See also* Sager & Cohen, *supra,* at 1076-78.

For example, the taxpayer in *Alexander v. IRS,* 72 F.3d 938, 946-947 (1st Cir.1995), obtained a favorable settlement of her employment discrimination suit. However, legal fees and the high costs of her court battle left her with a net recovery of only $5,000, but a tax bill of $53,900. Sager & Cohen, *supra,* at 1078 & n.15. Similarly, in *Coady v. Commissioner,* 213 F.3d 1187 (9th Cir. 2000), after prevailing in her bench trial on her claim that she was wrongfully discharged, Mrs. Coady was left with a tax liability greater than her net recovery, telling a reporter, "I won the battle, but I lost the war." Brigid McMenamin, "The Lawyers Did Just Fine," Forbes, Apr. 1, 2002, at 80.

Such outcomes prompted the office of the National Taxpayer Advocate, within the IRS, to state that the include-deduct method "deviates from the concept of taxing net income" and does not bring about a fair result for taxpayers in nonphysical personal injury cases. National Taxpayer Advocate, *Annual Report to Congress*, Publication 2104 (Rev. 12-2002), p. 166. The Taxpayer Advocate added, "The result would be the same whether the attorney's fee arose from a contingent fee agreement or a court-ordered award." *Id.* at 162.

In fact, the unfairness of the Commissioner's include-deduct theory is even more egregious in such

cases because court-awarded fees may, for good reason, well exceed the monetary award to the plaintiff. *Riverside v. Rivera,* 477 U.S. 561, 574 (1986). Nevertheless, the IRS has applied its theory to court awarded fees under federal fee-shifting statutes

One such case that came to national attention is that of police officer Cynthia Spina. For eight years, she endured a campaign of sexual harassment by her coworkers and superiors. Sexual rumors were spread through her workplace, pornography repeatedly was placed on her desk, her tires were slashed, she was passed over for assignments and promotions, and fellow officers refused to back her up in dangerous situations. *See Spina v. Forest Preserve Dist. of Cook County,* 207 F. Supp. 2d 764 (N.D. Ill. 2002). She prevailed in a hard-fought sex discrimination and harassment lawsuit under Title VII. The damage award was $300,000, and attorney fees and costs totaled almost $1,000,000. *Spina v. Forest Preserve Dist. of Cook County,* No. 98 C 1393 (D. Ill., July 30, 2002) (granting plaintiff's fee petition). Because the IRS required Spina to report the court-awarded fee as income, according to her lawyer,[3] "She loses every penny of the award plus she will end up owing the Internal Revenue Service $99,000." Adam Liptak, "Tax Bill Exceeds Award To Officer in Sex Bias Suit," N.Y. Times, August 11, 2002, at A12. *See also* "Outrageous Injustice," Newsday, Aug. 17, 2002.

The prospect that a "victorious" plaintiff may be required to pay for the privilege may lead some

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[3] Ms. Spina was represented by ATLA member Monica E. McFadden, of Chicago.

Americans to believe that their government has taken back the promise that was wrested from King John in 1215: "To no one will we sell, to no one will we refuse or delay, right or justice." William S. McKechnie, MAGNA CARTA 395 (2d ed. 1914). Many will simply decide that they cannot afford justice.

B. Inclusion of Attorney Fees As Income to Plaintiffs In Nonphysical Personal Injury Cases Undermines the Purpose of Federal and State Laws.

1. Unfair Taxation Hinders States' Ability to Enforce Their Own Subtantive Tort Laws.

The harm caused by Commissioner's include-deduct treatment of attorney fees in personal injury cases is not limited to the unfairness to individual taxpayers like those before this Court. Obviously, the threat that the IRS will take an excessively large bite out of the net recovery is a powerful disincentive to those who may seek to vindicate their rights. Without private enforcement, personal rights protected by state and federal law may become hollow promises.

Few of the reported cases addressing this issue involve plaintiffs like Banaitis, asserting rights under state law.[4] *See e.g., Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000), cert. denied, 532 U.S. 972 (2001) (wrongful discharge); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000)

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[4] Banaidis's underlying lawsuit was based on state tort rules protecting not only employment relationships, but also the confidentiality of trade information, as the jury's special verdict reflects. See 340 F.3d at 1077.

(defamation). Nevertheless, most tort law is state law. Approval of the Commissioner's tax treatment of fees in nonphysical personal injury cases will affect plaintiffs in a wide variety of state tort actions, such as invasion of privacy, false imprisonment, intentional infliction of emotional distress, and causes of action created by state statute.

The purpose of substantive tort law is not only to make whole the victim, but also to deter misconduct and prevent such harms in the first place. See American Bar Association, TOWARDS A JURISPRUDENCE OF INJURY 4-3 (1984) (deterrence of misconduct is "a strong thread running through tort law"); W. Page Keeton et al., PROSSER AND KEETON ON THE LAW OF TORTS § 4 (5th ed. 1984); Clarence Morris, *Punitive Damages in Tort Cases*, 46 Harv. L. Rev. 1173, 1177 (1931) (both compensatory and punitive damages serve tort law's "admonitory" function of deterring misconduct); Robert D. Cooter, *Economic Analysis of Punitive Damages*, 56 So. Cal. L. Rev. 79, 137 (1982) ("There is now a rich body of academic literature supporting the view that a primary purpose of tort liability rules is to discourage inappropriate behavior.").

"It is beyond dispute," this Court has emphasized, that the States have "a significant interest in redressing injuries that actually occur within the State." *International Paper Co. v. Ouellette*, 479 U.S. 481, 502-503 (1987). Though the supremacy of federal law sweeps broadly, this Court has cautioned that the "State's interest in applying its own tort laws cannot be superseded by a federal act unless that was the clear and manifest purpose of Congress." *Id.* Similarly, in *Farmer v. Carpenters*, 430 U.S. 290 (1977), where the Court held that the

NLRA did not pre-empt a union member's suit against his union for intentional infliction of emotional distress, the Court pointed out that federal law must take into account the legitimate and substantial interest of the State in protecting its citizens through tort liability. *Id.* at 304.

Keeping in mind that "[t]he power to tax involves the power to destroy." *McCulloch v. Maryland,* 17 U.S. (4 Wheat.) 316, 431 (1819), this Court should reject the Commissioner's invitation to adopt a tax treatment of state tort damages that undermines a State's ability to enforce its own substantive tort law.

2. Excessive Taxation Undermines the Objectives of Federal Laws

Most reported cases addressing this issue have involved taxpayers who, like Banks, succeeded in vindicating their rights under federal civil rights statutes. Those plaintiffs obtained legal representation under contingency fee agreements under which the attorney would be paid a percentage of any settlement. Frequently, where such cases proceed to trial, a prevailing plaintiff may move for attorney fees under a fee-shifting statute. Taxpayer Banks, for example, could have moved for an award of attorney fees if the parties had not settled and Banks had prevailed in his Title VII claims.

Without question, unlawful discrimination "is a fundamental injury to the individual rights of a person," *Goodman v. Lukens Steel Co.*, 482 U.S. 656, 661 (1987), that causes grave harm to its victims. *United States v. Burke,* 504 U.S. 229, 238 (1992).

Congress enacted the federal civil rights statutes not only to make those victims whole, but

also with "the central statutory purposes of eradicating discrimination throughout the economy." *Albemarle Paper Co. v. Moody,* 422 U.S. 405, 420-421 (1975); *United States v. Burke,* 504 U.S. 229, 250 (1992) (O'Connor, J., dissenting). Individual lawsuits serve as "the chosen instrument of Congress to vindicate 'a policy that Congress considered of the highest priority.'" *Christiansburg Garment Co. v. EEOC,* 434 U.S. 412, 418 (1978), quoting *Newman v. Piggie Park Enterprises Inc.*, 390 U.S. 400, 402 (1968).

Congress also recognized that if plaintiffs acting as a "private attorney general" were forced to bear their own litigation costs, "few aggrieved parties would be in a position to advance the public interest." *Piggie Park, supra,* at 401-02. "Congress therefore enacted the provision for counsel fees . . . to encourage individuals injured by racial discrimination to seek judicial relief." *Id.*[5] Courts may properly award attorney fees in such cases in excess of the monetary damages awarded to the plaintiff. *Riverside v. Rivera,* 477 U.S. 561, 574 (1986) (upholding award of $245,456 in attorney fees where a jury awarded damages totaling $33,350);

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[5] See, e.g., Civil Rights Attorney's Fees Awards Act of 1976, 42 U.S.C. § 1988(b) ("In any action or proceeding to enforce a provision of sections 1981, 1982, 1983, 1985, and 1986 of this title, title IX of Public Law 92-318 . . . , or title VI of the Civil Rights Act of 1964 . . . , the court, in its discretion, may allow the prevailing party, other than the United States, a reasonable attorney's fee as part of the costs."). Congress enacted similar fee-shifting provisions in the Civil Rights Act of 1964, 42 U.S.C. § 2000a-3(b); Civil Rights Acts of 1964, 42 U.S.C. § 2000e-5(k); Americans With Disabilities Act of 1990, 42 U.S.C. § 12205; Fair Housing Act, 42 U.S.C. § 3612(p) (1994); the Voting Rights Act Amendments of 1975, 42 U.S.C. § 1973l (e).

Copeland v. Marshall, 205 U.S. App. D.C. 390, 400-410, 641 F.2d 880, 890-900 (1980) (upholding attorney fees of $160,000 for representing a plaintiff who recovered $30,000).

In the event of settlement, of course, fees are generally allocated by a contingency fee agreement, rather than court award. However, it is the prospect of a substantial fee award that motivates defendants to make settlement offers that will compensate both attorney and client and, ultimately, allow victims of discrimination to obtain competent legal representation. Separate tax treatment of contingency fees and statutory fee awards would therefore be unworkable.[6]

This Court's approval of the Commissioner's include-deduct tax treatment of such fees would have the cruelly ironic result of *discouraging* those with meritorious cases from seeking judicial redress. Few aggrieved persons are likely to pursue their claims if this Court announces that they thereby obligate themselves to report as income an unknown sum of money they will never see and which could leave

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6 The Commissioner states that the rule would apply only in cases involving taxable damage awards. Brief of Petitioner at n.5. However, the Commissioner's arguments are not so limited. If a plaintiff prevails in a case, obtaining important injunctive relief but nominal or no monetary damages, the fee award would appear to have the same status under the Commissioner's application of the assignment of income doctrine or the view that the fee satisfies a debt owed by the client to the attorney. See Edward A. Morse, *Taxing Plaintiffs: A Look At Tax Accounting For Attorney's Fees and Litigation Costs,* 107 Dick. L. Rev. 405, 481 (2003) ("consistency would require extending similar treatment to awards under fee-shifting statutes -- regardless of whether any monetary awards are ultimately collected").

them owing the IRS more than they recover. "This Draconian result," it has rightly been stated, "can only undermine our civil rights laws." *Sinyard v. Commissoner*, 268 F.3d 756, 763 (9th Cir. 2001) (McKeown, J., dissenting).

Moreover, this Court's approval of the Commissioner's position would likely extend such draconian results far beyond employment discrimination cases. Congress has enacted an estimated 150 fee-shifting statutes whose purpose is "to enable private parties to obtain legal help in seeking redress for injuries resulting from the actual or threatened violation of specific federal laws." *Pennsylvania v. Delaware Valley Citizens' Council for Clean Air,* 478 U.S. 546, 565 (1986). Charles Silver, *Unloading The Lodestar: Toward A New Fee Award Procedure,* 70 Tex. L. Rev. 865, 873 (1992) (estimating 150 fee-shifting statutes); *Marek v. Chesny,* 473 U.S. 1, 43-51 (1985) (Appendix to dissenting opinion of Brennan, J., listing fee-shifting statutes).

Many States have also adopted legislation providing court-awarded fees. *See, e.g., Abrams v. Lightolier, Inc.,* 50 F.3d 1204 (3d Cir. 1995) (applying New Jersey fee-shifting statute in connection with employment discrimination claim); *McGinnis v. Kentucky Fried Chicken*, 51 F.3d 805 (9th Cir. 1994) (applying Washington fee-shifting statute in employment discrimination case); *Flannery v. Prentice,* 28 P.3d 860 (Cal. 2001) (attorney fees awarded under California's Fair Employment and Housing Act).

3. The Include-Deduct Tax Treatment of Attorney Fees Unnecessarily Increases the Costs of Settlements.

Congress, of course, did not intend to promote litigation for its own sake. Congress aimed to eliminate discrimination and to make whole its victims. Good faith settlements of meritorious claims further this objective. However, as many trial lawyers can attest, the include-deduct tax treatment of attorney fees introduces additional complexity, uncertainty, and expense into settlement negotiations. Counsel must undertake a thorough review of the tax impact that fees may have on the client and adjust settlement demands upward to avoid an unanticipated and unjust outcome. Defendants, as a result, may expect to face more difficult and expensive settlements. Tax considerations figured into Respondent Banks's settlement negotiations, for example. 345 F.3d at 376.

It may also be expected that courts, recognizing that Congress did not intend to penalize successful civil rights claimants, will endeavor to avoid unfair tax consequences of fee awards. For example, in *Blaney v. International Ass'n of Machinists & Aerospace Workers*, 55 P.3d 1208, 1210 (Wash. Ct. App. 2002), the court awarded plaintiff a supplemental judgment to offset the tax consequences of attorney fees awarded under a state fee-shifting statute. In *Porter v. United States Agency for International Development*, 293 F. Supp.2d 152, 157 (D.D.C. 2003), the district court tentatively declined to "gross up" plaintiff's fee award to offset potential taxes, but fashioned its award "to ensure that the attorneys' fee award never becomes a tax problem for Porter." *Id.* at 157.

II. THE IRS POSITION IS BASED ON AN ERRONEOUS APPLICATION OF THIS COURT'S JUDICIAL DOCTRINES REGARDING INCOME.

A. The Assignment of Income Doctrine Does Not Apply To Attorney Fee Agreements.

How does the Commissioner support a result that even courts that accept it say "smacks of injustice," *Alexander, supra*, 72 F.3d at 946, "unfairness," *Sinyard, supra,* 268 F.3d at 760, and creates "a terror for civil rights plaintiffs." *Jalali v. Root,* 109 Cal. App.4th 1768, 1775, 1 Cal Rptr. 3d 689, 693 (2003)?

Oddly, apart from stressing that I.R.C. § 61(a) includes in gross income "all income from whatever source derived,"[7] the Commissioner does not base the

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[7] The Court's interpretation of this section in *Commissioner v. Glenshaw Glass*, 348 U.S. 426 (1955), relied upon in Brief of Petitioner at 15, is indeed broad, but not unbounded. The Court used a three-prong test for determining gross income, looking to taxpayers' "undeniable accessions to wealth, clearly realized, and over which taxpayers have complete dominion." 348 U.S. at 431. It is difficult to agree that taxpayers in this case either "clearly realized" or had "complete dominion" over the fees retained by their attorneys which taxpayers never saw and never had the right to spend on anything other than attorney fees. Nor did they experience "undeniable accessions to wealth" where neither taxpayers' net worth nor personal consumption were increased by the amount of the fees.

Rather, the fees fall within the basic principle that "that a person's taxable income should not include the cost of producing that income." *Hantzis v. Commissioner*, 638 F.2d 248, 249 (1st Cir. 1981). See also National Taxpayer's Advocate, *supra,* at 166, stating that inclusion of attorney fees "deviates from the concept of taxing net income."

inclusion-deduction treatment of attorney fees in nonphysical injury cases on provisions enacted by Congress in the Code. Indeed, this "anomalous result [was] no doubt unintended" by Congress. *Sinyard, supra,* 268 F.3d at 759. Or, as more memorably phrased by the California Court of Appeal, "Chalk another one up to the law of unintended consequences." *Jalali v. Root*, supra, 109 Cal. App. 4th at 1781, 1 Cal. Rptr. 3d at 698 (2003).

The Commissioner instead relies on an interpretation of judge-made doctrine, which has been referred to as "the Federal common law of taxation as adopted by the Supreme Court." *Kenseth, supra*, 114 T.C. at 432 (Beghe, J., dissenting). Primarily, the Commissioner relies on the "assignment of income" doctrine set forth by this Court in *Lucas v. Earl*, 281 U.S. 111 (1930), and *Helvering v. Horst,* 311 U.S. 112 (1940). Brief for the Petitioner at 18-22.

Lucas arranged to have half his salary paid directly to his wife. Horst had the interest earned by his bonds paid directly to his son by detaching and giving the negotiable bond coupons to his son. The Court in both cases held that the salary or bond interest was income to the donor.

The basic principle at work, the Commissioner recognizes, is to ensure that income is taxed to the person who earns it. Brief of Petitioner at 19 & 20. The doctrine serves as a "cornerstone of our graduated income tax system," *United States v. Bayse,* 410 U.S. 441, 450 (1973), by ignoring for tax purposes gratuitous transfers of income from the person who earned it to a lower-bracket donee.

The doctrine simply does not apply to attorney-client fee agreements. It cannot be argued that the attorney who secures a favorable verdict or settlement has not earned his or her fee. Nor does the Commissioner assert that these agreements shift income to a lower bracket taxpayer. Moreover, the issue resolved in *Lucas* and *Horst* was whether the income more properly belongs to the taxpayer *or* the donee. As has been noted, the assignment of income doctrine does not result in attributing the income to both. *See Estate of Clarks v. United States*, 202 F.3d 854, 857 (6th Cir. 2000).

The most crucial distinction, however, is that Lucas and Horst were taxpayers who retained ownership or control over an income-producing asset, while attempting to redirect the stream of income that was produced. Lucas did not give up his job; Horst did not part with his bonds. As the Court in *Horst* stated, "where the donor retains control of the trust property the income is taxable to him although paid to the donee." 311 U.S. at 119.

Much confusion, it appears, comes from the attempts to characterize the contingency agreement as the transfer of the fruits of the client's orchard or some of its trees. *See* Brief of Petitioner at 29. Judge Cardozo has warned that "[m]etaphors in law are to be narrowly watched, for starting as devices to liberate thought, they end often by enslaving it." *Berkey v. Third Ave. Ry. Co.*, 155 N.E. 58, 61 (N.Y. 1926) (Cardozo, J.).

ATLA suggests that the significant event is not the signing of the contingent fee agreement, which is a nontaxable event. Rather it is the payment of the settlement or judgment. The Commissioner correctly states that "the settlement

proceeds represent the value given in exchange for the dismissal of respondents' claims." Brief of Petitioner at 12.

Unlike Lucas and Horst, the taxpayer's cause of action does not produce income while he retains ownership and control of the asset. Rather, Banks and Banaitis relinquished their claim entirely, agreeing to pay their counsel a percentage of the proceeds. This, ATLA submits, is in the nature of a sale or disposition of property.[8] ATLA argues in Part III, below, that the tax rules applicable to legal fees in connection to such sales or dispositions should apply.

B. Characterizing Attorney Fees as Satisfaction of a Debt Does Not Support Include-Deduct Tax Treatment.

The Commissioner asserts that the "relationship between the client and his attorney is simply that of debtor and creditor." Brief of Petitioner at 13. The payment of attorney fees, the Commissioner reasons, is in satisfaction of that debt, resulting in income to the debtor-taxpayer under *Old Colony Trust Co. v. Commissioner,* 279 U.S. 716, 720 (1929). Brief of Petitioner at 19.

ATLA suggests that this approach is not useful here, where there is no pre-existing debt. Under a contingency fee agreement, until the defendant makes payment in exchange for release of the plaintiff's claim, the client owes nothing to the lawyer.

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[8] *Cf. Srivastava v. Commissioner*, 220 F.3d 353, 359 (5th Cir.2000) ("the doctrine does not apply to a taxpayer who transfers, sells, or otherwise relinquishes an asset)

Constructing a debt in these circumstances leads to anomalous results. For example, a client's contingency fee may amount to $10,000. It is not uncommon for a trial lawyer in a case where high expenses and low recovery would leave the client with little compensation, to reduce his or her fee, perhaps in this instance by $1,000. However, forgiveness of indebtedness is also income to the debtor. Under the Commissioner's view, the client would have to report as income $11,000 on an attorney fee of $10,000.

Moreover, the creditor-debtor theory does not address the most egregiously unfair application of the include-deduct tax treatment: Court awarded fees under fee-shifting statutes. Congress enacts such statutes as an exception to the general rule that a party is responsible for his or her own legal fees. *Alyeska Pipeline Services. Co. v. Wilderness Soc'y*, 421 U.S. 240, 247 (1975). Payment of fees awarded by the court are in satisfaction of a debt which is debt by the *defendant,* not the client, to the attorney. As Judge McKeown noted in his dissent in *Sinyard, supra*, "the district court taxed attorney's fees against IDS. When IDS paid those fees to the Sinyards' attorneys, IDS satisfied its own statutory obligation. *Old Colony* is inapposite." 268 F.3d at 762 (McKeown, dissenting).

Again, the situation more closely resembles a disposition of property. If a taxpayer sells stock and pays the broker an agreed percentage of the proceeds, the IRS does not view the payment as the satisfaction of a debt owed to the broker. Rather, broker's commission is subtracted from the price paid to arrive at gross income. Treas. Reg. § 1.263(a)-2(e) (1987). As ATLA argues in Part III, below, similar

treatment is appropriate for fees allocable to personal injury damages.

C. Include-Deduct Tax Treatment Is Not Required To Avoid Favoring Contingency Fees Over Hourly Fees.

The Commissioner's third contention is in the nature of a policy argument: To permit taxpayers to exclude attorney contingency fees from gross income would create "an artificial, a purely tax- motivated, incentive to substitute contingent for hourly legal fees." Brief of Petitioner at 33, quoting *Kenseth, supra*, 259 F.3d at 884.

The Commissioner's concern is on a par with locking the barn door to keep fish from escaping to the river. The truth is that almost no individuals retain an attorney in a nonphysical personal injury case on an hourly fee basis. The reasons for this are legitimate and entirely non-tax related. First, and most important, many individuals simply could not afford to pay for legal representation on an hourly basis. Indeed, it is precisely because many aggrieved persons "cannot afford to purchase legal services at the rates set by the private market" that Congress has enacted fee-shifting statutes. *Rivera, supra,* 477 U.S. at 576.

Second, even if a client can afford to pay by the hour, a contingency fee agreement shifts the risk of loss of the case to the attorney, who is generally better equipped to bear that risk. Third, the contingency fee assures that the lawyer's interests are firmly aligned with the clients: The lawyer earns more not by billing more hours, but by obtaining more compensation for the client. *See* Charles Silver, *Due Process and the Lodestar Method: You Can't Get*

There From Here, 74 Tulane L. Rev. 1809 (2000) (noting a "broad consensus that percentage-based formulas harmonize the interests of agents and principals better than time-based formulas").

In short, taxation of contingent fees to clients will not motivate people to retain lawyers on an hourly basis. Rather, they are likely to abandon efforts to enforce their legal rights altogether. *Rivera. supra*, 477 U.S. at 578.

Nor does Commissioner's policy argument address the tax treatment of court-awarded fees, which are hourly-based and not a matter of the client's choice.

Moreover, the Commissioner has not established that attorney fees paid on a fixed or hourly basis would necessarily be deductible if contingent fees were excluded from income.[9] There appears no reason why such fees could not receive the same treatment. For example, in *Ward. v. Commissioner*, 20 T.C. 332 (1953), the Tax Court held that a fixed fee retainer paid to an attorney in connection with the sale of a partnership is not deductible, but "is to be used as an offset against the selling price just like any other expenditure made in connection with the sale of a capital asset." *Id.* 342

III. DAMAGES RECEIVED ON ACCOUNT OF PERSONAL INJURY ARE PROCEEDS OF A

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9 The Commissioner asserts that the taxpayers here have conceded if they had paid their attorneys on an hourly basis the fee "would have been an deduction from, not a reduction of" gross income. Brief of Petitioner at 25. Commissioner provides no citation to the record evidencing such a concession.

DISPOSITION OF PROPERTY, FROM WHICH ATTORNEY FEES ARE SUBTRACTED AS A CAPITAL EXPENSE.

A. A Judgment or Settlement of a Personal Injury Cause of Action Is A Disposition of Property.

The Commissioner supports the inclusion of attorney fees as income to both the taxpayer the attorney with this analogy: "[W]hen an individual uses a portion of his salary to pay for the services of a plumber, the same income is taxed to both the individual and the plumber." Brief of Petitioner at 34.

ATLA offers a different analogy that is closer to the mark. A taxpayer who wants to sell his or her house may retain the services of a real estate agent on a contingent basis. If the house sells, the agent receives a commission, perhaps 6% of the sales price. As the IRS correctly instructs taxpayers, the gain on the sale is the sales price minus selling expenses, including the agent's commission (and any legal fees). Internal Revenue Service, "Selling your Home," Pub. 503, at 3-4 (2003).[10]

I.R.C. § 1001(a) states that the "gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis." I.R.C. § 1012 provides that the "basis of property shall be the cost of such property," and I.R.C. § 1016 requires that "[p]roper adjustment

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[10] If the Commissioner's plumber installs a new water heater, that expense is capitalized by adding it to the basis of the property, regardless that the taxpayer used taxable salary to pay the plumber.

in respect of the property shall in all cases be made (1) for expenditures, receipts, losses, or other items, properly chargeable to capital account."

The proper adjustment for recovery of capital expenditures, this Court has explained, occurs through an offset to the selling price, rather than deduction. *Woodward v. Commissioner,* 397 U.S. 572, 574-75 (1970) For example, attorney fees paid in connection with the sale of stock "are an offset against the selling price." Treas. Reg. § 1.263(a)-2(e) (1987).

A vested cause of action is, of course, "a species of property." *Logan v. Zimmerman Brush Co.*, 455 U.S. 422, 428 (1982); *Martinez v. California*, 444 U.S. 277, 281 (1980). The Code classifies a cause of action, or "chose in action," as "intangible personal property." As the Internal Revenue Manual explains:

> Intangible personal property includes "choses in action." . . . A chose in action is a personal right not reduced to possession and recoverable by a suit at law. A plaintiff's cause of action in tort against a defendant is an example of a chose in action.

I.R.M 5.17.2.4.3.4 – Intangible Property (2000). *See, e.g., Jeffrey v. United States,* 261 B.R. 396, 401 (2001) (taxpayer's unliquidated medical malpractice cause of action held to be intangible personal property).

I.R.C. § 1001 and its associated provisions are not limited to the sale or disposition of capital assets. *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79, 87 (1992) ("creation of a separate and distinct asset . . . not a necessary, condition to classification as a capital expenditure."); *See* Edwin A. Morse, *Taxing Plaintiffs: A Look At Tax Accounting for Attorney's*

Fees and Litigation Costs, 107 Dick. L. Rev. 405, 474 (2003) ("It is important to recognize that "offset" treatment is not limited to situations where capital-gain producing assets are involved.").

In any event, a taxpayer's cause of action is a clearly a capital asset under the Code. Under I.R.C. § 1221, intangible personal property falls within the definition of a capital asset unless it is excluded as being property used in the taxpayer's trade or business that is subject to the allowance for depreciation.

The status of an unliquidated cause of action as property, subject to the tax rules governing the sale or other disposition of property, is evident in this case. Taxpayer Banks purchased his cause of action against DOE from his estate in bankruptcy for $10,000. *Banks v. Commissioner*, T.C. Memo. 2001-048 (Tax Ct. 2001). The Tax Court excluded the $10,000 purchase price from Banks' gross income from the settlement. *Id.*

There remains only the question of whether payment of a settlement or judgment that releases the defendant from liability constitutes a sale, exchange or "other disposition" of property under § 1001. The Commissioner himself suggests the answer is yes, stating that in this case, "the settlement proceeds represent the value given in exchange for the dismissal of respondents' claims." Brief of Petitioner at 12.

For example, in *Siple v. Commissioner*, 54 T.C. 1, 7 (1970), where Siple received $30,000 from Mizner in return for a contingent claim against Mizner and his company, the Tax Court stated that "the transaction involved the sale or exchange of capital assets"

This reflects longstanding practice, even under the more restrictive predecessor sections of the Internal Revenue Code of 1939. In *Herbert's Estate v. Commissioner,* 139 F.2d 756, 758 (3rd Cir. 1943), for example, Herbert's claim against a corporation was paid by the corporation to the estate. In the court's view, Herbert's "estate had a chose in action, property, which it got rid of or relinquished upon payment. . . . We have no doubt that the payment here of the claim held by the estate was a 'disposition' of the claim within the meaning of Sec. 111."

Courts have long viewed the release by one party of the legal obligations of another as a sale or disposition of a property interest. In *Commissioner v. Golonsky,* 200 F.2d 72, 74 (3rd Cir. 1953), the court found it "no longer open to doubt" that choses in action are intangible property and that the release of such a right falls within the broad definition of a sale or exchange of property. Similarly, in *Appalachian Elec. Power Co. v. United States,* 158 F. Supp. 138, 140 (Ct. Ct. 1958), the court agreed with plaintiff that an agreement releasing defendants' obligations under a prior contract was the sale or exchange of a capital asset and "should receive capital assets treatment for tax purposes." *See also Ray v. Commissioner,* 18 T.C. No. 52 (1952) (lessee's release to lessor of a restrictive covenant held to be a sale of a capital asset); *Benedum v. Granger*, 180 F.2d 564, 566 (3rd Cir. 1950) ("Mr. Benedum having held 'property,' a chose in action, exchanged it for other less valuable property. The transaction clearly constitutes an exchange of capital assets.")

In sum, ATLA submits that legal fees in connection with damages on account of nonphysical

personal injury should be treated as capital expenditures and offset against the total recovery to arrive at gross income. Commissioner has pointed to no specific Code provision that would require such fees to be treated as deductions. As this Court has made clear, "deductions are exceptions to the norm of capitalization." *INDOPCO, Inc. v. Commissioner,* 503 U.S. 79, 84 (1992) "[C]apital expenditures, by contrast, are not exhaustively enumerated in the Code. . . For these reasons, deductions are strictly construed and allowed only as there is a clear provision therefor." *Id.*

B. Capitalization of Attorney Fees Does Not Violate The "Source of the Claim" Doctrine.

In Brief for Amici Curiae Professor Gregg D. Polsky and Professor. Brant J. Hellwig, the professors, without discussing capitalization of legal fees in detail, suggest that including only the net proceeds of an award or settlement would do violence to yet another judge-made doctrine, the origin of the claim rule. Id. at 15-16 n.15. Under that doctrine, they state, "the cause of action is disregarded as a separate asset" and the nature of the underlying claim determines the tax treatment of the associated legal expenses. *Id.*

In ATLA's view, this extends the doctrine far beyond its purpose. The "origin of the claim" rule, which this Court first enunciated in *United States v. Gilmore,* 372 U.S. 39 (1963), addresses whether a taxpayer may take a deduction for legal fees as a business expense under I.R.C. § 162, or as an expense for the production or collection of income under I.R.C. § 212. 6 MERTENS LAW OF FEDERAL INCOME TAXATION § 25A:04 (2004). In *Gilmore*, for

example, the Court heid that the husband's legal fees in a divorce proceeding were "personal," rather than business expenses.

However, the doctrine has no application to the antecedent question of whether the taxpayer has income in the first place. The rule is designed to properly classify the legal expenses incurred to secure or maintain the production of income from income producing property. *See* MERTENS, *supra*. But it does not apply to the legal expense incurred in the sale or disposition of that asset. As this Court made clear in *Woodward v. Commissioner*, 397 U.S. 572, 575 (1970), "[i]f an expense is capital, it cannot be deducted," under either § 162 or 212. "The law could hardly be otherwise, for such ancillary expenses incurred in acquiring or disposing of an asset are as much part of the cost of that asset as is the price paid for it." *Id.* at 575 & 576.

The professors' fears that, unless this Court adopts the include-deduct treatment of legal fees, the distinction between income and property under the Code would "be effectively eliminated," Brief of Amici at n.15, are overblown. When legal fees for personal injury damages are subtracted to arrive at taxpayer's gross income, the rule remains that the nature of the underlying claim determines whether the taxpayer's income is ordinary or capital gain.

For example, taxpayer Banks in this case paid $10,000 to acquire his cause of action from the estate in bankruptcy. The Tax Court subtracted that $10,000 from the settlement to arrive at Banks' gross income. *Banks v. Commissioner,* T.C. Memo. 2001-048 (Tax Ct. 2001). The is no dispute that if Banks had incurred legal expenses in that acquisition, they would also be excluded from income, as *Woodward*

makes clear. Capitalization of these costs and expenses do not depend upon the origin of the claim. However, the damages paid on account of the claim, by virtue of the proper application of the origin of the claim doctrine, are ordinary income.

There is no persuasive reason, under the Code or in common sense, to treat the legal fees incurred to obtain damages in nonphysical personal injury cases as anything other than a capital expense, offset, under *Woodward*, against the settlement to arrive at taxpayer's gross income.

CONCLUSION

For the above reasons, the decisions of the courts of appeals should be affirmed.

Respectfully submitted,

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NOS. 03-892 and 03-907

IN THE
Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, *Petitioner,*

v.

JOHN W. BANKS, II, *Respondent*

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*

v.

SIGITAS J. BANAITIS, *Respondent*

On Writs of Certiorari
to the United States Courts of Appeals
for the Sixth and Ninth Circuits

BRIEF FOR *AMICUS CURIAE*, PROF. STEPHEN B. COHEN, *PRO SE*, IN SUPPORT OF RESPONDENTS

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INTEREST AND IDENTITY OF *AMICUS*[1]

This *Amicus* brief offers a new argument concerning the question presented, which has not been raised by the parties or considered by the courts below.

Amicus is a scholar and teacher, who is co-author of a series of articles on the federal income tax treatment of attorneys' fees.[2] He is currently a Professor of Law at Georgetown University Law Center in Washington, D.C., where he has taught federal income taxation for the past twenty-five years. He has also taught taxation at Harvard, Rutgers, Stanford, and Wisconsin Law Schools. Except for his academic interests, he has no interest in the outcome of these cases.

Amicus believes that the government's position produces unnecessarily harsh results, which Congress never intended. He therefore respectfully asks this Court to consider his brief in support of the taxpayers.

---

[1] This brief is submitted with the parties' written consent, copies of which have been filed with the Clerk. Pursuant to Rule 37.6, *Amicus* affirms that no counsel for any party authorized this brief in whole or in part. The cost of printing will be reimbursed by Georgetown University Law Center, where *Amicus* is a faculty member. Otherwise only *Amicus* has made a monetary contribution for the preparation and submission of this brief.

[2] Stephen Cohen and Laura Sager, *Final(?) Thoughts on the Biehl Decision*, 99 Tax Notes 133 (2003); "*Judicial Activism*" *Should Not Prolong the Attorney's Fee Problem*, 98 Tax Notes 377 (2003); *Kafka at the Tax Court*, 96 Tax Notes 1503 (2002); *How the Income Tax Undermines Civil Rights Law*, 73 Southern California Law Review 1075 (2000).

SUMMARY OF ARGUMENT

The question presented in *Commissioner v. Banks*, No. 03-892, and *Commissioner v. Banaitis*, No. 03-907, is whether a taxpayer's gross income under Internal Revenue Code § 61(a), 26 U.S.C. § 61(a), includes or excludes the portion of the taxpayer's recovery paid to the taxpayer's attorneys in employment litigation. The answer determines whether Mr. Banks and Mr. Banaitis are taxed, under the Alternative Minimum Tax, on an artificially large amount, namely the total recovery, without any allowance for the attorneys' fees. The answer also determines whether the government will be permitted to interpret the Internal Revenue Code to undermine federal civil rights statutes that prohibit employment discrimination.

The opinions and briefs below assumed that the answer to the question presented depends solely on arguments involving the assignment of income doctrine. This *Amicus* brief offers an entirely different argument: that the taxpayers' gross income excludes the amount paid to their attorneys because that amount satisfies the requirements of Internal Revenue Code § 62(a)(2)(A), 26 U.S.C. § 62(a)(2)(A), for a reimbursed business expense of an employee. Treasury Regulation § 1.62-2(c)(4), 26 C.F.R. § 1.62-2(c)(4), provides that such reimbursed employee business expenses are excluded from gross income. The Court has in the past decided cases on grounds raised only by an *Amicus* and therefore may consider § 62(a)(2)(A), even though this provision was not previously raised or considered in these cases.[3]

For reasons explained in detail in the Argument below, the expenses for the attorneys' fees satisfy the requirements

[3] The Appendix contains the relevant parts of the texts of Internal Revenue Code § 62(a) and Treasury Regulation § 1.62-2.

of the plain language of § 62(a)(2)(A) and the regulations thereunder. Moreover, applying § 62(a)(2)(A) to these expenses is entirely consistent with the congressional purpose of excluding from gross income employee business expenses that do not provide significant personal consumption benefits. Employees, such as Mr. Banks and Mr. Banaitis, do not sue their employers for amusement or recreation.

In principle, it is clear that under an income tax, Mr. Banks and Mr. Banaitis should be taxed only on the net recovery, after an allowance for the attorneys' fees, which are the cost of generating the recovery. What is right in principle should apply in practice with particular force to the Alternative Minimum Tax, which has the objective of providing a more accurate measure of a taxpayer's income than the regular tax.

The government's position—that the Alternative Minimum Tax applies to the entire recovery without any allowance for the attorneys' fees—undermines federal civil rights statutes prohibiting discrimination in employment. These statutes contain fee-shifting provisions, which entitle the prevailing plaintiff in civil rights litigation to recover reasonable attorneys' fees from the defendant. The fee-shifting provisions enable the civil rights plaintiff who cannot pay an attorney, and whose potential recovery is not sufficient for a contingency fee arrangement, to sue for relief. However, if the plaintiff's gross income includes the entire recovery, without any allowance for the attorneys' fees, then the "successful" civil rights plaintiff may retain little or none of the damages after paying taxes and, in some cases, may even suffer a net loss. The government's position therefore frustrates the objective of the fee-shifting provisions, which is to encourage the private enforcement of federal civil rights laws.

The Ninth Circuit's decision in *Biehl v. Commissioner*, 351 F.3d 982 (9th Cir. 2003), that § 62(a)(2)(A) can never apply to the expenses of a former employee, should be rejected. The Ninth Circuit ignored the rule that identical words used in different parts of the same statute are presumed to have the same meaning, misinterpreted Treasury regulations, and misread the legislative history. The Ninth Circuit also made no attempt to harmonize the Internal Revenue Code with federal civil rights statutes, did not consider § 62(a)(2)(A)'s purpose, and ignored the admonition that Congress cannot anticipate every problem that may arise.

For these reasons, *Amicus* respectfully asks this Court to hold that the attorneys' fees in these cases qualify as reimbursed employee business expenses under § 62(a)(2)(A) and thus are excludable from gross income under Treasury Regulation § 1.62-2(c)(4).

ARGUMENT

I. This *Amicus* Brief Presents a New Argument for Excluding the Attorneys' Fees from Taxpayers' Gross Income.

In *Commissioner v. Banks*, No. 03-892, the taxpayer received $464,000 in settlement of an employment discrimination lawsuit, of which he paid $150,000 to his attorney, retaining $314,000 for himself. *Banks v. Commissioner*, 345 F.3d 373, 376 (6th Cir. 2003). In *Commissioner v. Banaitis*, No. 03-907, the taxpayer settled an unlawful-termination-of-employment lawsuit for $8,728,559, of which $3,864,012 was paid directly to his attorney, while the taxpayer received $4,864,547. *Banaitis v. Commissioner*, 340 F.3d 1074, 1078 (9th Cir. 2003).

The question presented in these cases is whether the taxpayers' gross income under Internal Revenue Code § 61(a), 26 U.S.C. § 61(a) includes or excludes the portion of the taxpayers' recovery paid as attorneys' fees. The answer determines whether, under the Alternative Minimum Tax, Mr. Banks and Mr. Banaitis are to be taxed on an artificially large amount, namely the entire recovery, without any allowance for the attorneys' fees, which are the cost of generating the recovery. The answer has special significance because it also determines whether the government will be permitted to interpret the Internal Revenue Code to undermine federal civil rights statutes that prohibit employment discrimination.

The opinions and briefs below assumed that the answer to the question presented depends solely on arguments involving the assignment of income doctrine. *See Banks*, 345 F.3d at 382-86; *Banaitis*, 340 F.3d at 1081-83. This *Amicus* brief presents an entirely different argument, which

was not raised by the parties or considered by the courts of appeals below: that the taxpayers' gross income excludes the portion of the recovery paid to their attorneys because that amount satisfies the requirements of Internal Revenue Code § 62(a)(2)(A), 26 U.S.C. § 62(a)(2)(A), as a reimbursed business expense of an employee.

A. Gross Income Does not Include Amounts that Qualify under Internal Revenue Code § 62(a)(2)(A) as Reimbursed Employee Business Expenses.

Treasury Regulation § 1.62-2(c)(4), 26 C.F.R. § 1.62-2(c)(4) provides that gross income does not include any amount that qualifies under § 62(a)(2)(A) as a reimbursed employee business expense. The regulation states that "[a]mounts treated as paid under an accountable plan are excluded from the employee's gross income." *Id.* An "accountable plan" is defined by Treasury Regulation § 1.62-2(c)(2)(i), 26 C.F.R. § 1.62-2(c)(2)(i), as an arrangement that meets the requirements of § 62(a)(2)(A).[4]

B. The Court May Consider an Argument Raised for the First Time in an *Amicus* Brief.

In *Lebron v. National R.R. Passenger Corp.*, 513 U.S. 374 (1995), this Court observed that "[o]nce a federal claim is properly presented, a party can make any argument in support of that claim; parties are not limited to the precise arguments they made below." 513 U.S. at 378-79. *See*

[4] Under Treasury Regulation § 1.62-2(c)(2)(i), an "accountable plan" is "an arrangement [that] meets the requirements of paragraphs (d), (e), and (f)" of Treasury Regulation § 1.62-2. As explained in Part II of this Argument, *infra* page 8, paragraphs (d), (e), and (f) of Treasury Regulation § 1.62-2 mirror the requirements of § 62(a)(2)(A).

also Yee v. Escondido, 503 U.S. 519, 534 (1992); *Dewey v. Des Moines*, 173 U.S. 193, 198 (1899). This observation applies to an *Amicus* as well, as the Court has in the past decided claims on grounds raised only in an *Amicus* brief. *Teague v. Lane*, 489 U.S. 288, 300 (1989); *Mapp v. Ohio*, 367 U.S. 643, 646, n.3 (1961). Thus, the Court may consider the applicability of § 62(a)(2)(A) even though this provision was not previously raised or considered in these cases.

II. The Attorneys' Fees Satisfy the Plain Language Requirements of § 62(a)(2)(A).

Section 62(a)(2)(A) provides that to qualify as a reimbursed employee business expense, the expense must be "paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer." Internal Revenue Code §§ 62(c)(1) and 62(c)(2), 26 U.S.C. §§ 62(c)(1), 62(c)(2), further define "reimbursement or other expense allowance arrangement" for the purposes of § 62(a)(2)(A). Under § 62(c)(1), the arrangement must "require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement." Under § 62(c)(2), the arrangement must not provide "the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement."

The plain language of §§ 62(a)(2)(A), 62(c)(1), and 62(c)(2) therefore imposes four requirements in order for a reimbursed employee business expense to qualify for exclusion from gross income. First, the expense must be paid or incurred "under a reimbursement or other expense allowance arrangement with [the taxpayer's] employer." § 62(a)(2)(A). Second, the expense must be paid or

incurred "in connection with the performance by [the taxpayer] of services as an employee." § 62(a)(2)(A). Third, the arrangement must "require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement." § 62(c)(1). Fourth, the arrangement must not provide "the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement." § 62(c)(2).

Treasury regulations mirror the four requirements imposed by the plain language of the statute. Treasury Regulation § 1.62-2(b), 26 C.F.R. § 1.62-2(b), requires "a reimbursement or other expense allowance arrangement." Treasury Regulation § 1.62-2(c)(1), 26 C.F.R. § 1.62-2(c)(1), defines a reimbursement or other expense allowance arrangement as "an arrangement that meets the requirements of paragraphs (d) (business connection), (e) (substantiation), and (f) (returning amounts in excess of expenses)." Treasury Regulation § 1.62-2(d)(1), 26 C.F.R. § 1.62-2(d)(1), requires that the expense be "paid or incurred by the employee, in connection with the performance of services as an employee of the employer." Treasury Regulation § 1.62-2(e)(1), 26 C.F.R. § 1.62-2(e)(1), requires "each business expense to be substantiated to the payor." Treasury Regulation § 1.62-2(f)(1), 26 C.F.R. § 1.62-2(f)(1), requires "the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the expenses substantiated."

A. The Settlement Agreements Qualify as Reimbursement Arrangements.

In both *Banks* and *Banaitis*, the settlement agreements were intended and understood by the taxpayers and their employers not only to compensate the taxpayers for the

damages suffered, but also to reimburse the taxpayers for their attorneys' fees. In *Banks*, the settlement agreement specified that the parties were settling all of the plaintiff's claims, *Banks*, 345 F.3d at 376, one of which was for attorneys' fees under the fee-shifting provisions of 42 U.S.C. §§ 1981 and 1983 and Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e et seq. *Banks*, 345 F.3d at 375-76. The employer made out a single check payable to the taxpayer, who then paid the attorneys' fees from the settlement amount. *Id.* at 376. In *Banaitis*, under the terms of the settlement agreement, the employer made out two separate checks, one payable to the taxpayer for the amount of damages, the other payable to the taxpayer's attorneys for the amount of their fees for legal services. *Banaitis*, 340 F.3d at 1078.

When a term in the Internal Revenue Code, such as "arrangement," is not specially defined, the rule is that the term should be given its ordinary, everyday meaning. *Commissioner v. Soliman*, 506 U.S. 168, 173 (1993); *Malat v. Riddell*, 383 U.S. 569, 571 (1966). One of the ordinary, everyday dictionary definitions of the word "arrangement" is a settlement or agreement. The Oxford English Dictionary includes among the definitions of arrangement "[a] settlement of mutual relations or claims between parties; an adjustment of disputed or debatable matters; a settlement by agreement." The Oxford English Dictionary, Second Edition 645 (1989). Webster's Third New International Dictionary of the English Language defines an arrangement, among other things, as "a settlement or adjustment esp. [especially] of a dispute or claim." Webster's Third New International Dictionary of the English Language, Unabridged 120 (2002).

The language of § 62(a)(2)(A) and of the regulations thereunder contains no special requirements for or

definition of an "arrangement" beyond the in-connection-with-the-performance-of-services-as-an-employee language of § 62(a)(2)(A) and the substantiation and no-retention-of excess-reimbursement-amount provisions of §§ 62(c)(1) and 62(c)(2). Indeed, Treasury Regulations explicitly confirm that there are no special extra-statutory requirements for a "reimbursement or other expense allowance arrangement." As noted above, Treasury Regulation § 1.62-2(c)(1) defines a reimbursement or other expense allowance arrangement simply as "an arrangement that meets the requirements of paragraphs (d) (business connection), (e) (substantiation), and (f) (returning amounts in excess of expenses)." Therefore, the settlements in *Banks* and *Banaitis*, under which the employers agreed to reimburse the expenses incurred by the taxpayers for their attorneys' fees, should qualify as reimbursement arrangements under § 62(a)(2)(A) provided that the taxpayers satisfy these three requirements.

B. The Fees Arose in Connection with the Performance of Services by the Taxpayers as Employees.

It is well settled that the expenses of a former employee in prosecuting a wrongful-termination-of-employment claim qualify under Internal Revenue Code § 162(a), 26 U.S.C. § 162(a), as "ordinary and necessary expenses paid or incurred during the taxable year in carrying on" the trade or business of an employee. *Alexander v. Commissioner*, 72 F.3d 938, 945 (1st Cir. 1995); *Biehl v. Commissioner*, 118 T.C. 467, 477 (2002), *aff'd*, 351 F.3d 982 (9th Cir. 2003); *McKay v. Commissioner*, 102 T.C. 465, 489 (1994), vacated and remanded on another issue, 84 F.3d 433 (5th Cir. 1996)

(unreported decision).[5] Thus, the attorneys' fees, which were the expenses of prosecuting the wrongful-termination-of-employment claims in both *Banks* and *Banaitis*, constitute "ordinary and necessary expenses paid or incurred during the taxable year in carrying on" the business of an employee under § 162(a).

Moreover, the business of an employee (as opposed to a self-employed taxpayer) is defined as the performance of services as an employee, and this definition applies whether or not the taxpayer is currently employed. *Alexander*, 72 F.3d at 945 and n.13; *McKay*, 102 T.C. at 488; *O'Malley v. Commissioner*, 91 T.C. 352, 363-64 (1988); *Primuth v. Commissioner*, 54 T.C. 374, 377 (1970). This definition is incorporated, for example, in Internal Revenue Code § 62(a)(1), 26 U.S.C. § 62(a)(1), which defines a nonemployee business by what it is not, that is, a business that "does not consist of the performance of services by the taxpayer as an employee."[6] Thus, because the expenses for the attorneys' fees in these cases were incurred in carrying on the business of an employee under § 162(a), and because the business of an employee is defined as the performance

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[5] Although the government at one time took a contrary position, *McKay*, 102 T.C. at 488-89, it has now conceded this point. *Biehl*, 351 F.3d at 984.

[6] In *Alexander*, the First Circuit construed the performance-of-services-as-an-employee language in § 62(a)(1) to include former as well as current employees. 72 F.3d at 944-45. In *Biehl v. Commissioner*, 351 F.3d 982 (9th Cir. 2003), the Ninth Circuit acknowledged the First Circuit's construction of this language in § 62(a)(1) as including former as well as current employees and did not dispute that construction. 351 F.3d at 987. Nevertheless the Ninth Circuit held that virtually identical language in § 62(a)(2)(A) could never include a former employee. *Id.* at 986. Part V of this Argument, *infra*, explains why the Ninth Circuit's decision in *Biehl* should be rejected.

of services as an employee, the expenses were incurred in carrying on the business of the performance of services as an employee.

Over half a century ago, the Supreme Court construed the words "in carrying on" under the predecessor of § 162(a) to mean "that there must be a direct connection between the expenditure and the carrying on of the trade or business of the taxpayer." *Commissioner v. Flowers*, 326 U.S. 465, 470 (1946).[7] Since *Flowers*, the touchstone of the inquiry into whether an expense is paid or incurred "in carrying on" a business under § 162(a) has been whether there is a sufficient business connection. *Commissioner v. Stidger*, 386 U.S. 287, 289-90 (1967); *Henderson v. Commissioner*, 143 F.3d 497, 499-501 (9th Cir. 1998); *Hantzis v. Commissioner*, 638 F.2d 248, 250, 252, 254-55 (1st Cir. 1981); *Rosenspan v. United States*, 438 F.2d 905, 909 (citing *Flowers*), 910 (citing *Stidger*) (2d Cir. 1971). Because the attorneys' fees in these cases were expenses incurred "in carrying on" the business of the performance of services as an employee under § 162(a), the expenses necessarily had a "direct connection" with that business under *Flowers*, 326 U.S. at 470, and were therefore "in connection with the performance by [the taxpayer] of services as an employee," as required by § 62(a)(2)(A).

To recapitulate, it is well settled that the attorneys' fees in these cases were expenses incurred "in carrying on" the business of an employee under § 162(a). *Alexander*, 72 F.3d at 945; *Biehl*, 118 T.C. at 477; *McKay*, 102 T.C. at 489. Moreover, the business of an employee is defined as

[7] The predecessor of current § 162(a) was § 26(a)(1)(A) of the 1939 Internal Revenue Code, 26 U.S.C. § 26(a)(1)(A) (1939). Both provisions, using identical language, refer to "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business."

the performance of services as an employee, whether or not the taxpayer is currently employed. *Alexander*, 72 F.3d at 945 and n.13; *McKay*, 102 T.C. at 488; *O'Malley v. Commissioner*, 91 T.C. 352, 363-64 (1988); *Primuth v. Commissioner*, 54 T.C. 374, 377 (1970). Therefore, the attorneys' fees were expenses incurred in carrying on the performance of services as an employee. In addition, since the courts have defined "in carrying on" as meaning a "direct connection," *Flowers*, 326 U.S. at 470; *Stidger*, 386 U.S. at 289-90, it follows that the expenses for the attorneys' fees were paid or incurred "in connection with" the performance of services as an employee under § 62(a)(2)(A)—unless some reason compels a construction of the phrase "in connection with" in § 62(a)(2)(A) that means something very different from the "direct connection" required by this Court's construction of § 162(a).

To the contrary, construing the "in connection with" language of § 62(a)(2)(A) as satisfied whenever an expense is paid or incurred "in carrying on" the business of the performance of services as an employee under § 162(a) comports with the sorting function that § 62(a)(2)(A) performs in conjunction with § 62(a)(1). Section 62(a)(1) applies to all business expenses except those attributable to the business "of the performance of services by the taxpayer as an employee." In other words, § 62(a)(1) applies to all nonemployee business expenses.

Employee business expenses, on the other hand, are governed by § 62(a)(2)(A), which is satisfied for expenses "in connection with the performance of services by [the taxpayer] as an employee," provided that the employee expenses are paid or incurred under a reimbursement arrangement, which is defined as an arrangement that meets the substantiation and no-retention-of-excess-

reimbursement-amount requirements of §§ 62(c)(1) and 62(c)(2). The "in connection with" language of § 62(a)(2)(A) therefore, operates as a sorting device, ensuring that all employee business expenses are tested by the reimbursement arrangement that meets the substantiation and no-retention-of-excess-reimbursement-amount requirements of §§ 62(c)(1) and 62(c)(2), while nonemployee business expenses—those falling under § 62(a)(1)—are not subject to such requirements.

C. The Fee Amounts Were Substantiated, and the Taxpayers Did Not Retain Excess Reimbursement Amounts.

The substantiation and no-retention-of-excess reimbursement amount requirements of §§ 62(c)(1) and 62(c)(2) are clearly satisfied by the facts of *Banks* and *Banaitis*. The amount of the attorneys' fees is substantiated in each case by reference to the contingency fee agreement and the total settlement amount. *Banks*, 345 F.3d at 376; *Banaitis*, 340 F.3d at 1078.[8]

Moreover, in neither case did the taxpayer retain any of the amount paid by the employer to reimburse the expense for the attorney's fee. *Id.* In *Banks*, although the attorneys' fees were paid by the plaintiff out of the proceeds of a

[8] Under § 62(c)(1), the reimbursement arrangement must "require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement." Read literally, § 62(c)(1) only states that the reimbursement arrangement must impose a substantiation requirement but does not state that the employee must actually comply with that requirement. Treasury Regulation § 1.62-2(e)(3), 26 C.F.R. § 1.62-2(e)(3), takes a more practical approach, focusing on whether substantiation is in fact provided rather than on whether the arrangement requires substantiation. *Brenner v. Commissioner*, T.C. Memo 2001-127.

single settlement check, it is undisputed that the taxpayer paid the full amount required by the contingency fee agreement to his attorneys. 345 F.3d at 376. In *Banaitis*, it would have been impossible for the taxpayer to retain any excess since the portion of the settlement amount that was allocated to the attorneys' fees was paid directly to the attorney. 340 F.3d at 1078.[9]

Thus, the expenses for the attorneys' fees in both *Banks* and *Banaitis* satisfy the requirements of §§ 62(a)(2)(A), 62(c)(1), and 62(c)(2) and the regulations thereunder. Pursuant to Treasury Regulation § 1.62-2(c)(4), the portion of the recovery paid to the attorneys should be excluded from the taxpayers' gross income.

III. Applying § 62(a)(2)(A) Is Consistent with the Statute's Purpose of Excluding from Taxation Business Expenses that Do Not Provide Personal Consumption Benefits.

The Internal Revenue Code sharply distinguishes between employee business expenses that qualify as reimbursed under § 62(a)(2)(A) and employee business expenses that do not. Reimbursed employee business

[9] Under § 62(c)(2), the reimbursement arrangement must not allow "the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement." The regulations interpret § 62(c)(2) to mean something more than a prohibition; the reimbursement arrangement must affirmatively require "the employee to return to the payor" any excess amount. Treas. Reg. § 1.62-2(f)(1). This command, however, is further modified by the statement that "whether an arrangement requires an employee to return amounts in excess of substantiated expenses will depend on the facts and circumstances." Treas. Reg. § 1.62-2(f)(1). Under the practical "facts and circumstances" test of Treasury Regulation § 1.62-2(f)(1), the requirements of § 62(c)(2) are satisfied in both *Banks* and *Banaitis*.

expenses are excluded from gross income pursuant to Treasury Regulation § 1.62-2(c)(4). Unreimbursed employee business expenses, on the other hand, are subject to important disadvantages.

Although includible in gross income, such unreimbursed employee business expenses are: (1) deductible only if the taxpayer does not elect the standard deduction; (2) deductible only to the extent that they and other specified expenses exceed two percent of adjusted gross income; (3) subject to a phase-out once adjusted gross income exceeds a specified level; and (4) most significant for the taxpayers in *Banks* and *Banaitis*, not deductible at all under the Alternative Minimum Tax.[10]

According to the legislative history, there are two reasons why Congress decided to subject unreimbursed employee business expenses to these serious disadvantages. First, Congress was concerned that such expenses provide

[10] Employee business expenses that do not satisfy §§ 62(a)(2)(A), 62(c)(1), and 62(c)(2) are not deductible in computing adjusted gross income. § 62(a)(2)(A). Expenses that are not deductible in computing adjusted gross income are "itemized deductions." Internal Revenue Code § 63(d), 26 U.S.C. § 63(d). Itemized deductions are also "miscellaneous itemized deductions" unless specially exempted, and unreimbursed employee business expenses are not among the exempted items. Internal Revenue Code § 67(b), 26 U.S.C. § 67(b). Miscellaneous itemized deductions are (1) deductible only if the taxpayer does not elect the standard deduction, Internal Revenue Code §§ 63(b) and 63(e), 26 U.S.C. §§ 63(b), 63(e); (2) deductible only to the extent that the aggregate amount of such deductions exceeds two percent of adjusted gross income, Internal Revenue Code § 67(a), 26 U.S.C. § 67(a); (3) subject to a phase-out (along with most other itemized deductions) once adjusted gross income exceeds a specified amount, Internal Revenue Code § 68, 26 U.S.C. § 68; and (4) not deductible at all under the Alternative Minimum Tax. Internal Revenue Code § 56(b)(1)(A)(i), 26 U.S.C. § 56(b)(1)(A)(i).

taxpayers with significant personal consumption benefits, which in principle should be taxed. The Joint Committee on Taxation explained that employee business expenses that do not satisfy § 62(a)(2)(A) "have characteristics of voluntary personal expenditures" and may "convey personal and recreational benefits" to the employee. Staff of the Joint Comm. on Taxation, 99th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 78-79 (Comm. Print 1987).[11] The 1988 Conference Committee Report accompanying the enactment of §§ 62(c)(1) and 62(c)(2) noted that "some unreimbursed expenses that an employee chooses to incur are sufficiently personal in nature that they would be incurred apart from the taxpayer's performance of services as an employee . . . ." H.R. Conf. Rep. No. 100-998, at 202 (1988).

This first reason is also reflected in the language of § 62(c)(2), which prohibits the employee from retaining reimbursement amounts in excess of substantiated expenses. The objective is to prevent taxpayers from excluding from gross income excess cash reimbursement

[11] The quoted passages explain the justification for § 67(a), which limits the regular tax deduction for unreimbursed employee business expenses, to the extent that they and other specified expenses exceed two percent of adjusted gross income. Neither the Joint Committee on Taxation, nor the House and Senate reports explained the justification for § 56(b)(1)(A)(i), which subjects such items to the Alternative Minimum Tax. Staff of the Joint Comm. on Taxation., 99th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 78-79 (Comm. Print 1987); H.R. CONF. REP. NO. 99-841, pt. 2, at 259-60 (1986); S. REP. NO. 99-313, at 535 (1986). However, it is reasonable to assume that the justification for § 67(a) applies to § 56(b)(1)(A)(i) as well, since both provisions were enacted at the same time as part of the same legislation and since both provisions limit the deduction of employee business expenses that do not satisfy § 62(a)(2)(A). Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986).

amounts that can be used for personal rather than business purposes.

Second, Congress believed that unreimbursed employee business expenses generally involve small amounts and therefore impose burdensome recordkeeping and enforcement requirements on both taxpayers and the Internal Revenue Service.

> For taxpayers who anticipated claiming [such] deductions, prior law effectively required extensive record keeping with regard to what commonly are small expenditures. Moreover, the fact that small amounts typically were involved presented significant administrative and enforcement problems for the Internal Revenue Service.

Staff of the Joint Comm. on Taxation., 99th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 78 (Comm. Print 1987) (footnote omitted).

Neither reason for the tax disadvantages imposed on unreimbursed employee business expenses applies in these cases. The attorneys' fees that employees, such as Mr. Banks and Mr. Banaitis, incur in suing their former employers obviously are not for amusement or recreation and provide no significant personal consumption benefits. Moreover, the attorneys' fees in these cases are not the kind of relatively small expenditures for meals, entertainments, and the like that present disproportionate recordkeeping and enforcement burdens on taxpayers and the Internal Revenue Service.

The fact is that Congress never intended to include within the category of unreimbursed employee business expenses, subject to full taxation under the Alternative Minimum Tax, the large amount of attorneys' fees that are

incurred in employment litigation and provide no significant personal consumption benefits. Construing § 62(a)(2)(A) to apply to the expenses for attorneys' fees in these cases and excluding such fees from the taxpayers' gross income pursuant to Treasury Regulation § 1.62-2(c)(4) is entirely consistent with the purpose of the statute.

IV. Applying § 62(a)(2)(A) Avoids a Result that Is Grossly Unfair and Irrational and that Undermines Federal Civil Rights Statutes.

As a matter of principle, it is clear that under an income tax, Mr. Banks and Mr. Banaitis should be taxed only on the recovery, net of the attorneys' fees, which are the cost of generating the recovery. No serious economist or lawyer would argue that in *Banks*, the taxpayer's income from the employment litigation was $464,000 rather than the $314,000 net amount that the taxpayer actually retained or, in *Banaitis,* was $8,728,559 rather than the $4,864,547 net amount that the taxpayer actually received. What is right in principle should apply in practice with particular force to the Alternative Minimum Tax, which has the objective of providing a more accurate measure of taxable income than the regular tax. *See* Daniel J. Lathrope, The Alternative Minimum Tax: Compliance and Planning with Analysis, ¶ 1.02, at 1-2 to 1-3 (1994).

Thus, courts have often observed that the government's position on the tax treatment of attorneys' fees in employment litigation is arbitrary, irrational, and unfair because it produces a taxable income figure for purposes of the Alternative Minimum Tax that greatly exceeds the taxpayer's actual income amount. *See, e.g., Alexander*, 72 F.3d at 946; *Banks* 345 F.3d at 385; *Sinyard v. Commissioner,* 268 F.3d 756, 762-63 (9th Cir. 2001)

(Judge McKeown, dissenting); *Srivastava v. Commissioner*, 220 F.3d 353, 363-65 (5th Cir. 2000). Moreover, the National Taxpayer Advocate, an independent office established by Congress, has listed the irrational and unfair treatment of attorneys' fees as one of six major problem areas in the federal income tax. National Taxpayer Advocate, FY 2002 Annual Report to Congress, 156, 160-62 (2002).

The government's position in *Banks* and *Banaitis* produces especially harsh results when a plaintiff sues for employment discrimination under federal civil rights statutes. In civil rights cases, the plaintiff's damages are often too modest to enable the plaintiff to obtain representation under a contingency fee agreement that promises the attorney a percentage of the damages. *City of Riverside v. Rivera*, 477 U.S. 561, 577 (1986) (plurality opinion). Therefore, Congress has provided for the prevailing plaintiff in civil rights litigation to recover not only damages, but also a reasonable amount to pay for the services of the plaintiff's attorneys. 42 U.S.C. § 1988(b) (Civil Rights Attorney's Fees Awards Act of 1976); 42 U.S.C. § 2000a-3(b) (Civil Rights Act of 1964); 42 U.S.C. § 2000e-5(k) (Civil Rights Act of 1964); 42 U.S.C. § 12205 (Americans with Disabilities Act of 1990). The potential attorneys' fees award enables the civil rights plaintiff whose damages are not sufficient for a contingency fee agreement to obtain representation. *City of Riverside*, 477 U.S. at 576-79; *Quaratino v. Tiffany & Co.*, 166 F.3d 422, 426 (2d Cir. 1999).

When the damages for employment discrimination are modest compared to the attorneys' fees, the government's position will result in the civil rights plaintiff retaining little or none of the damages after paying taxes on the gross recovery, which includes the attorneys' fees as well as the

damages. In some cases, the "successful" plaintiff may even suffer a net loss because the tax liability will exceed the damages received.

A New York Times article provides a striking example of such a case. Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, The New York Times, August 11, 2002, p. 18. The article discusses *Spina v. Forest Preserve District of Cook County*, 207 F. Supp. 2d 764 (N.D. Ill. 2002). In *Spina*, a police officer who sued her employer for sex discrimination, including sexual harassment, in violation of Title VII of the 1964 Civil Rights Act, was awarded $300,000 in compensatory damages, 207 F. Supp. 2d at 779, plus $950,000 for her attorneys' fees, *Spina v. Forest Preserve District of Cook County*, 2002 WL 1770010, at *9 (N.D. Ill. 2002). The fee award was especially large because of the extraordinary dilatory and obstructionist tactics of the defendant. *Id.* at *4.

If the government's position in *Banks* and *Banaitis* prevails, the Alternative Minimum Tax will apply to the entire $1,250,000 amount in *Spina*. Assuming that the taxpayer files singly and has no other income or deductions, her Alternative Minimum Tax liability would be about $345,000, or $45,000 more than her compensatory damage award.[12]

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[12] For a single taxpayer, up to $40,250 of income is exempt from the Alternative Minimum Tax. § 55(d)(1)(B), 26 U.S.C. § 55(d)(1)(B). However, the exemption amount is subject to a phase-out, which in this example reduces that amount to zero. § 55(d)(3)(B), 26 U.S.C. § 55(d)(3)(B). Thus, income above the exemption amount is $1,250,000. The first $175,000 of income above the exemption amount is taxed at a rate of 26%. Any additional income is taxed at a rate of 28%. § 55(b)(1)(A)(i), 26 U.S.C. § 55(b)(1)(A)(i). The tax due on the first $175,000 of income is $45,500. The tax due on the $1,075,000 of additional income is $301,000. Thus, the total tax due under the Alternative Minimum Tax in this example is $346,500, and the net loss

As the facts of *Spina* illustrate, the government's position not only renders illusory the promise of damages for employment discrimination under federal civil rights statutes. It can also have the punitive effect of imposing a net loss on the "successful" plaintiff. If "success" in litigation means not only retaining little, if any, damages after taxes but also incurring a significant risk of a net loss, victims of employment discrimination will be reluctant to sue. The government's position, if adopted, will therefore have the practical effect of negating federal civil rights protections.

The government's position in these cases also ignores the obligation to construe a statute to "foster harmony" with other statutory law. *Digital Equip. Corp. v. Desktop Direct, Inc.*, 511 U.S. 863, 879 (1994). While the government's position undermines federal civil rights statutes, the application of § 62(a)(2)(A) to the expense for the attorneys' fees in these cases would instead foster harmony between the tax law and federal statutes prohibiting discrimination in employment.

V. The Ninth Circuit's Decision that § 62(a)(2)(A) Cannot Apply to a Former Employee Should Be Rejected.

Only one Court of Appeals decision has discussed in detail the question of whether § 62(a)(2)(A) applies to the portion of a settlement devoted to attorneys' fees in employment litigation.[13] In *Biehl v. Commissioner*, 351

to the prevailing plaintiff is nearly $46,500. The taxpayer must pay the amount owed under either the regular tax or the Alternative Minimum Tax, whichever is higher. Internal Revenue Code § 55(a), 26 U.S.C. § 55(a).

[13] In *Alexander*, 72 F.3d 938, the First Circuit briefly considered but did not discuss whether § 62(a)(2)(A) might apply to the portion of a

F.3d 982 (9th Cir. 2003), the Ninth Circuit held that § 62(a)(2)(A) does not apply to expenses incurred by a former employee because Congress's "use of the words 'performance' and 'employee' dictates that . . . the reimbursed expenses must be incurred during the course of employment." 351 F.3d at 986. In addition, the court indicated that in order to qualify under § 62(a)(2)(A), the employee must act "on behalf of the employer" when incurring the expense. *Id.* at 987. However, the Ninth Circuit's interpretation of § 62(a)(2)(A) should be rejected because it conflicts with the First Circuit's construction of virtually identical language in the adjacent Internal Revenue Code provision, § 62(a)(1) and is based on a misreading of the statute, the regulations, and the legislative history.

A. The Ninth Circuit Ignored the Rule that Identical Words in the Same Statute Are Presumed to Have the Same Meaning.

Section 62(a)(2)(A) contains the phrase, "the performance by him [i.e., the taxpayer] of services as an employee." Virtually identical language in § 62(a)(1) refers to "the performance of services by the taxpayer as an employee." It is a "normal rule of statutory

taxpayer's recovery paid to his attorney in employment litigation. Although the First Circuit held that § 62(a)(2)(A) could not apply to the case before it, the basis for its conclusion was not entirely clear. It appears that the First Circuit was concerned that the settlement agreement did not constitute a "reimbursement or other expense allowance arrangement" under § 62(a)(2)(A) either because the employer had not intended to reimburse the expense or because the expense amount was not adequately substantiated. The First Circuit noted that "the settlement agreement itself makes no mention of attorney's fees," 72 F.3d at 946, and cited the substantiation requirement, *id.*, n. 17.

construction . . . that identical words used in different parts of the same act are intended to have the same meaning." *Commissioner v. Lundy*, 516 U.S. 235, 250 (1996) (citation and internal quotation marks omitted).

In *Alexander v. Commissioner*, 72 F.3d 938 (1st Cir. 1995), the First Circuit construed the performance-of-services-as-an-employee language of § 62(a)(1) to include former as well as current employees. 72 F.3d at 944-45. As the First Circuit noted, "no distinction is made in § 62(a)(1) between present and former employees if the expenses originated in the trade or business of being an employee." *Id.* at 945.

Section 62(a)(2)(A) contains language that is virtually identical to § 62(a)(1) and, like the preceding subsection, makes no distinction between present and former employees. In *Biehl*, the Ninth Circuit acknowledged the First Circuit's construction of the performance-of-services-as-an-employee language in § 62(a)(1) as including former as well as current employees and did not dispute that construction. Nevertheless, the Ninth Circuit held that the performance-of-services-as-an-employee language in § 62(a)(2)(A) could never apply to a former employee. 351 F.3d at 987.

The Ninth Circuit justified ascribing different meanings to virtually identical language on the ground that § 62(a)(1) requires only that the expense be "attributable to a trade or business" while under § 62(a)(2)(A) the expense must also have been incurred "during the course of 'performance of services as an employee.' IRC § 62(a)(2)(A)." *Id.* at 986. However, the words "during the course of" do not appear in the statute. Rather, the statute says that the expense must have been incurred "in connection with the performance by [the taxpayer] of services as an employee." § 62(a)(2)(A) (emphasis added).

Furthermore, any assertion that a former employee's expense of prosecuting a wrongful-termination-of-employment claim might be "attributable to" under § 62(a)(1) but not "in connection with" under § 62(a)(2)(A) is without merit. In *Alexander*, the First Circuit held that such an expense was "attributable to" the business of the performance of services by the taxpayer as an employee under § 62(a)(1) because the "[t]axpayer's lawsuit was 'directly connected with, or proximately resulted from' his employment." 72 F.3d at 945 (citing *Kornhauser v. United States*, 276 U.S. 145, 153 (1928)). Moreover, because the expense of prosecuting a wrongful-termination-of-employment claim qualifies under § 162(a) as paid or incurred "in carrying on" the taxpayer's business as an employee, the expense is directly connected with the taxpayer's business as an employee and therefore necessarily arises "in connection with" that business. *See Flowers*, 326 U.S. at 470; *Stidger*, 386 U.S. at 289-90.

The Ninth Circuit's position—that the expenses in these cases, although "attributable to the business of the performance of services by the taxpayer as an employee" under § 62(a)(1), are not "in connection with the performance by [the taxpayer] of services as an employee" under § 62(a)(2)(A)—recalls the exchange between Humpty Dumpty and Alice in Lewis Carroll's Through the Looking Glass:

> "When I use a word," Humpty Dumpty said in rather a scornful tone, "it means just what I choose it to mean—neither more nor less."
>
> "The question is," said Alice, "whether you CAN make words mean so many different things."

Lewis Carroll, Through the Looking Glass, Chapter 6 (1872).

B. The Ninth Circuit Misinterpreted the Regulations.

The Ninth Circuit attempted to buttress its assertion that § 62(a)(2)(A) could never apply to the expenses of a former employee by citing regulations under § 62(a)(2)(A) that refer to an employee "*of the employer*." 351 F.3d at 986 (citing Treas. Reg. §§ 1.62-2(b), (d)(1)) (emphasis in the original). According to the Ninth Circuit, the of-the-employer phrase "reconfirm[s] that the expenses must have been incurred on behalf of the employer within a current employment relationship." 351 F.3d at 987. The court did not, however, explain why a current-employee requirement would be articulated imprecisely and vaguely through the words "of the employer" when the statute and regulations prescribe every other requirement in explicit, detailed language.

The Ninth Circuit also ignored the fact that similar language elsewhere in the Internal Revenue Code applies to former as well as current employees. The Internal Revenue Code, for example, requires an employer to withhold income and social security taxes on wages paid for: (1) "individuals in his employ," §§ 3111(a) and 3111(b), 26 U.S.C. §§ 3111(a), 3111(b); (2) "any service, of whatever nature, performed . . . by an employee for the person employing him," § 3121(b), 26 U.S.C. § 3121(b), 26 U.S.C. § 3121(b); and (3) "services performed by an employee for his employer", § 3401(a), 26 U.S.C. § 3401(a). These provisions have all been construed to mean that a former employer must withhold income and social security taxes on amounts paid to a former employee even if the amounts compensate the employee for wages that would have been earned after the termination of employment, that is, at a time when the employee was no longer a current employee. *Gerbec v. United States*, 164 F.3d 1015, 1026 (6th Cir. 1999); *Hemelt v. United States*, 122 F.3d 204, 210 (4th Cir. 1997). The Ninth Circuit offered no explanation why the words "of the employer" in Treasury regulations exclude former employees when similar phrases in the statute itself (such as "in his employ," "for the person employing him," and "for his employer") include former employees.

C. The Ninth Circuit Misread the Legislative History.

The Ninth Circuit also relied on a misreading of the legislative history to support adding both current-employee and on-behalf-of-the-employer requirements to the express language of § 62(a)(2)(A). The court's initial citation of the legislative history erroneously stated:

> The *General Explanation of the Tax Reform Act of 1986* defines an employee business expense as "a cost incurred by an employee in the course of performing his or her job." Staff of the Joint Comm. on Taxation, 99th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986* 78 (Comm. Print 1987). This strongly suggests that costs incurred after employment has terminated, such as wrongful termination litigation expenses, do not qualify.

351 F.3d at 986-87.[14]

However, the excerpt quoted by the Ninth Circuit refers to § 162(a), not to § 62(a)(2)(A). Staff of the Joint Comm. on Taxation, 99th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986* 76 (Comm.

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[14] The paragraph occurs on page 76 of the Report, not on page 78 as the Ninth Circuit's opinion indicates.

Print 1987). Therefore, the excerpt does not purport to define expenses that satisfy the requirements of § 62(a)(2)(A), as the court erroneously suggested. Moreover, any suggestion that a former employee cannot have a § 162(a) employee business expense is clearly wrong. As noted above, it is well settled that the costs of a former employee's prosecution of a wrongful termination claim qualify as a trade or business expense under § 162(a). *Alexander*, 72 F.3d at 945; *Biehl*, 118 T.C. at 477, *McKay*, 102 T.C. at 489.

The Ninth Circuit's claim that the legislative history "connotes" an on-behalf-of-the-employer requirement, 351 F.3d 986, is similarly misplaced. First, the court cited a 1988 Senate Report accompanying the Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342 to support a requirement that the employee act on behalf of the employer when incurring the expense. *Id.* at 987. (citing S. Rep. No. 100-445, at 7 (1988). However, the reference in the Senate Report is not to the employee acting on behalf of the employer but merely to an employer's arranging for a third party to reimburse the employee "on behalf of the employer." S. Rep. No. 100-445, at 7 (1988).[15] The Senate Report did not state that Congress intended to impose an on-behalf-of-the-employer requirement in addition to the other explicit, detailed requirements of the statute.

Second, the court cited references to "the employer's behalf" from a 1988 House Conference Report, 351 F.3d 987 (citing H.R. Conf. Rep. No. 100-998, at 203), which accompanied the enactment of §§ 62(c)(1) and 62(c)(2),

[15] The technical amendment added the last sentence of § 62(a)(2)(A), which permits a reimbursement to be made by a third party rather than by the employer. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, 102 Stat. 3342, 3349.

Family Support Act of 1988, Pub. L. No. 100-485, 102 Stat. 2343, 2426. However, these references should be understood in light of the specific abuse at which §§ 62(c)(1) and 62(c)(2) were aimed, namely, so-called "nonaccountable plans," under which "(1) the employee is not required to substantiate expenses . . . to the person providing reimbursement, or (2) the employee has the right to retain amounts in excess of the substantiated expenses . . . ." H.R. Conf. Rep. No. 100-998, at 201-02.

The references in the House Conference Report to expenses on "the employer's behalf," *id.* at 202-03, were clearly meant to contrast accountable plans, in which the taxpayer must substantiate the expenses and is not permitted to retain excess reimbursement amounts, with nonaccountable plans, in which such requirements are absent. These references do not support a requirement that the employee act on the employer's behalf when incurring the expense in addition to the explicit, detailed substantiation and no-retention-of-excess-reimbursement-amount requirements imposed by §§ 62(c)(1) and 62(c)(2). The Ninth Circuit did not explain why the legislative history of §§ 62(c)(1) and 62(c)(2) "connotes" an on-behalf-of-the-employer requirement, 351 F.3d 986, not contained in the words of the statute, when Congress set out every other requirement in explicit statutory language.

D. The Ninth Circuit Made No Attempt to Harmonize the Internal Revenue Code with Federal Civil Rights Statutes, Consider § 62(a)(2)(A)'s Purpose, or Heed the Admonition that Congress Cannot Anticipate Every Problem that May Arise.

The Ninth Circuit failed to apply other well-established principles of statutory construction. It did not consider

§ 62(a)(2)(A)'s purpose, which it was obligated to do, since the performance-of-services-as-an-employee language is hardly a model of clarity. *See Adams Fruit Co. v. Barrett*, 494 U.S. 638, 645-47 (1990). The court therefore appears to have forgotten Judge Learned Hand's admonition "to remember that statutes always have some purpose or object to accomplish." *Cabell v. Markham*, 148 F.2d 737, 739 (2d Cir. 1945). Nor did the court attempt to harmonize § 62(a)(2)(A) with other federal statutes, as required by prior Supreme Court decisions. *See Digital Equip. Corp.*, 511 U.S. at 879. Moreover, the court reasoned that § 62(a)(2)(A) never applies to attorneys' fees because Congress did not "anticipate" § 62(a)(2)(A)'s application, 351 F.3d 987, even though, as this Court has held, "Congress cannot be expected to anticipate every conceivable problem that can arise," *Bob Jones University v. United States*, 461 U.S. 574, 597 (1983).

CONCLUSION

For the reasons stated above, *Amicus* respectfully asks this Court to hold that the portion of the taxpayers' recovery in *Banks* and *Banaitis* that is paid as attorneys' fees qualifies as a reimbursed employee expense under Internal Revenue Code § 62(a)(2)(A) and thus is excludable from their gross income pursuant to Treasury Regulation § 1.62-2(c)(4).

RESPECTFULLY SUBMITTED, July 2003
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APPENDIX

I. Internal Revenue Code § 62, 26 U.S.C. § 62

Adjusted Gross Income Defined

(a) General rule

For purposes of this subtitle, the term "adjusted gross income" means, in the case of an individual, gross income minus the following deductions:

(1) Trade and business deductions

The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

(2) Certain trade and business deductions of employees

(A) Reimbursed expenses of employees

The deductions allowed by part VI (section 161 and following) which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer. The fact that the reimbursement may be provided by a third party shall not be

determinative of whether or not the preceding sentence applies.

* * * *

(c) Certain arrangements not treated as reimbursement arrangements

For purposes of subsection (a)(2)(A), an arrangement shall in no event be treated as a reimbursement or other expense allowance arrangement if--

(1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or

(2) such arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

* * * *

II. Treasury Regulation § 1.62-2, 26 C.F.R. § 1.62-2

Reimbursements and other expense allowance arrangements

* * * *

(b) Scope.

For purposes of determining "adjusted gross income," section 62(a)(2)(A) allows an employee a deduction for expenses allowed by part VI (section 161 and following), subchapter B, chapter 1 of the Code, paid by the employee, in connection with the performance of services as an employee of the employer, under a reimbursement or other expense allowance arrangement with a payor (the employer, its agent, or a third party). Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of section 62(a)(2)(A) if--

(1) Such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the payor, or

(2) Such arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

This section prescribes rules relating to the requirements of section 62(c).

(c) Reimbursement or other expense allowance arrangement-

(1) Defined.

For purposes of Sections 1.62-1, 1.62-1T and 1.62-2, the phrase "reimbursement or other expense allowance arrangement" means an arrangement that meets the requirements of paragraphs (d) (business connection, (e) (substantiation), and (f) (returning amounts in excess of expenses) of this section.

* * * *

(2) Accountable plans--

(i) In general.

Except as provided in paragraph (c)(2)(ii) of this section, if an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, all amounts paid under the arrangement are treated as paid under an "accountable plan."

(ii) Special rule for failure to return excess.

If an arrangement meets the requirements of paragraphs (d), (e), and (f) of this section, but the employee fails to return, within a reasonable period of time, any amount in excess of the amount of the expenses substantiated in accordance with paragraph (e) of this section, only the amounts paid under the arrangement that are not in excess of

the substantiated expenses are treated as paid under an accountable plan.

* * * *

(4) Treatment of payments under accountable plans.

Amounts treated as paid under an accountable plan are excluded from the employee's gross income, are not reported as wages or other compensation on the employee's Form W-2, and are exempt from the withholding and payment of employment taxes (Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), Railroad Retirement Tax Act (RRTA), Railroad Unemployment Repayment Tax (RURT), and income tax.) See paragraph (l) of this section for cross references.

* * * *

(d) Business connection--

(1) In general.

Except as provided in paragraphs (d)(2) and (d)(3) of this section, an arrangement meets the requirements of this paragraph (d) if it provides advances, allowances (including per diem allowances, allowances only for meals and incidental expenses, and mileage allowances), or reimbursements only for business expenses that are allowable as deductions by part VI (section 161 and the following), subchapter B, chapter 1 of the Code, and that are paid or incurred by

the employee in connection with the performance of services as an employee of the employer.

* * * *

(e) Substantiation--

(1) In general.

An arrangement meets the requirements of this paragraph (e) if it requires each business expense to be substantiated to the payor in accordance with paragraph (e)(2) or (e)(3) of this section, whichever is applicable, within a reasonable period of time. See section 1.274-5T or section 1.162-17.

* * * *

(3) Expenses not governed by section 274(d).

An arrangement that reimburses business expenses not governed by section 274(d) meets the requirements of this paragraph (e)(3) if information is submitted to the payor sufficient to enable the payor to identify the specific nature of each expense and to conclude that the expense is attributable to the payor's business activities. Therefore, each of the elements of an expenditure or use must be substantiated to the payor. It is not sufficient if an employee merely aggregates expenses into broad categories (such as "travel") or reports individual expenses through the use of vague, nondescriptive terms (such as

"miscellaneous business expenses"). See section 1.162-17(b).

(f) Returning amounts in excess of expenses--

(1) In general.

Except as provided in paragraph (f)(2) of this section, an arrangement meets the requirements of this paragraph (f) if it requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the expenses substantiated in accordance with paragraph (e) of this section. The determination of whether an arrangement requires an employee to return amounts in excess of substantiated expenses will depend on the facts and circumstances.

* * * *

(5) (L)

AUG 18 2004

No. 03-892/03-907

IN THE

Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

JOHN W. BANKS, II,
Respondent.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SIGITAS J. BANAITIS,
Respondent.

On Writ of Certiorari
To the United States Courts of Appeals
For the Sixth and Ninth Circuits

BRIEF FOR *AMICUS CURIAE* PROFESSOR CHARLES DAVENPORT IN SUPPORT OF RESPONDENTS

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INTEREST OF THE *AMICUS CURIAE*

This *Amicus Curiae* is a professor of law at Rutgers University, Newark, New Jersey. *Amicus* offers a theory not argued in the courts below. He has written a book on tax accounting, a book on the determination of cost for inventories, and, with another author, a second book on inventory costs. His interest lies in the proper application of tax doctrine. He has no other interest in the outcome of these cases.[1]

SUMMARY OF THE ARGUMENT

The cases at bar may be resolved by application of fundamental principles of federal income tax accounting not urged below by any of the parties.

The legal fees in these cases were incurred to acquire and dispose of Respondents' tort claims against their employers. Tort claims are intangible property. The costs of acquiring and disposing of property are transaction costs, and transaction costs are not deductible under either section 162 (dealing with business expenses) or 212 (dealing with investment expenses) of the Internal Revenue Code.[2] Rather, transaction costs are offset directly against the proceeds

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[1] Pursuant to this Court's Rule 37.3(a), letters from all parties consenting to the filing of this brief have been filed with Clerk. Pursuant to this Court's Rule 37.6, *Amicus* states that this brief was not authored in whole or in part by counsel for any party. *Amicus* received no monetary contribution for the preparation or submission of this brief other than reimbursement for the cost of printing this brief from Tax Analysts, a tax-exempt, nonprofit educational organization that has no interest in these cases but is interested, as a part of its exempt function, in sponsoring full debate on important tax issues. The views presented in this brief are those of the *Amicus* and should not be ascribed to either Tax Analysts or Rutgers University.

[2] 26 U.S.C. References to section numbers are to the Internal Revenue Code of 1986 unless otherwise noted.

earned by the costs. Because the fees are not deductions, they do not fall within the ambit of deductions disallowed in computing the alternative minimum tax (AMT).

The tax rules just stated are well-recognized, familiar tax doctrine routinely applied for many years. These rules provide certainty, and we need not set out on an endless sea to find another set of rules or perhaps to invent a new set of rules for these cases. The rules for transaction costs properly match costs against income. These rules are also administratively convenient. Finally, neither Petitioner nor *Amici Curiae* Professors Polsky and Hellwig give any good reason not to apply the rules for transaction costs to the cases before the Court. (Professors Polsky and Hellwig will be referred to as *Amici*.)

Petitioner's argument concerning assignments of income is fundamentally flawed. It relies on doctrine announced in cases of gratuitous assignment of income. Gratuitous assignments arise in friendly transactions where the only constraints on the form of the transaction are family wealth, family control, and hoped-for tax results. These circumstances justify careful scrutiny, and at the request of the IRS, the courts have developed unique rules for gratuitous assignments of income. These special rules are inapposite and should not be applied to assignments for consideration. Assignments for consideration are subject to well-developed income tax doctrine easy of application in these cases. As explained in the Argument below, Petitioner has issued recent rulings that flatly contradict its position in these cases.

Amici argue that IRC section 83(h) allows a deduction for the legal fees in these cases. It does not because the legal fees at issue are nondeductible transaction costs. The overriding principle that transaction costs may not be deducted is as applicable to IRC section 83(h) as it is to IRC sections 162 and 212. *Amici*'s reliance on section 83(h) is misplaced.

The theory set forth in this brief will achieve the right legal and the right economic result. The legal result follows from the argument above. The economic result is right because the income that is taxed under the AMT will be exactly equal to the economic benefit that the taxpayers received from their lawsuits. They will not be taxed on amounts far in excess of their economic gains as they will be under Petitioner's and *Amici*'s arguments.

ARGUMENT

I. Taxpayers' Legal Fees Are Transaction Costs, Not Deductions

A. Taxpayers' Tort Claims Are Property

These cases involve damage to a taxpayer's person but without physical injury and do not involve "personal injuries" within the meaning of section 104(a).[3] Even so, in tax literature, the injuries like the ones in these cases are sometimes called personal injuries.[4] This parlance prevails because the injury is to the person and results from tortious or quasi-tortious[5] conduct as distinguished from breaches of contracts.[6]

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[3] *United States v. Burke*, 504 U.S. 229 (1992), 122 S.Ct. 186, 119 L.Ed. 34; *Commissioner v. Schleier*, 513 U.S. 323, 115 S.Ct. 2159, 132 L.Ed. 294 (1995); *Ogilvie v. United States*, 519 U.S. 579, 117 S.Ct. 45, 136 L.ED. 454 (1996); and section 104(a) as amended.

[4] Raby, Burgess J.W. and William L. Raby, "Getting the IRS to Pay the Costs of a Tax Controversy," *Tax Notes*, July 12, 2004, page 173.

[5] The term "quasi-tortious" conduct is used because many of the taxpayers in cases presenting the issue before this Court founded their claims on statutory provisions conferring rights that had not been recognized by the common law. These cases are cited on page 3 of Brief for *Amici*.

[6] The argument in this brief is limited to cases of tort or quasi-tort injuries to the person. Broader application, if appropriate, may await another day. The cases in note 3 *supra* demonstrate the Court's familiarity with distinction between torts and contracts. Here the distinction is urged not to afford exemption from tax, but to define a class of cases that is well

These injuries to the person produce tort claims, and tort claims are property. In *Dames & Moore v. Regan*, 453 U.S. 654 (1981), this Court held that a cause of action could not be taken without compensation. Similarly, this Court has held that a tort claim may not be taken without due process. *New York Central Railroad Company v. White*, 243 U.S. 188 (1916). Even wispier intangibles are readily accepted as property in the tax law. For example, a customer-based intangible, a supplier-based intangible, know-how, a process, a format, or other similar items are recognized as property.[7] In *INDOPCO, Inc. v. Commissioner*, 503 U.S. 79 (1992), a mere future benefit (presumably from corporate synergies flowing from a merger) was enough to be treated as property.

Perhaps, Petitioner[8] will argue that injuries associated with one's person are not property because, if their disposition produces income, the income is ordinary income.[9] The argument seems to be that property unable to be converted to capital gain is somehow different, to the point of not being property at all, from property that may produce capital gain. Agreed. But only for the capital gain rules.[10] But the question whether or not the taxpayers' income is capital gain is not

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understood both by the Court and lower courts.

[7] See section 197(d) codifying prior practice.

[8] *Amici* argue that section 83 applies to the causes of action in these cases. Because section 83 applies only to property, an argument that the causes of action in these cases are not property would seemingly be difficult for *Amici* to sustain.

[9] Hellwig, Brant J., "Tax Treatment of Legal Fees: The Debate Continues," *Tax Notes*, Dec. 2, 2002, page 1235 and Brant J. Hellwig, "Davenport's Capitalization Argument Fails to Convince," *Tax Notes*, Jan. 20, 2003, page 433.

[10] *Hort v. Commissioner*, 313 U.S. 112, 61 S.Ct. 757, 85 L.Ed. 1168 (1941), *United States v. Midland-Ross*, 381 U.S. 54, 85 S.Ct. 1308, 14 L.Ed.2d 214 (1965). *Commissioner v. P.G. Lake, Inc.* 356 U.S. 260, 78 S.Ct. 691, 2 L.Ed.2d 743 (1958), *reh. denied* 356 U.S. 964, 78 S.Ct. 991, 2 L.Ed.2d 1071.

before the Court,[11] and the distinction has nothing to do with whether the taxpayers' causes of action are property for other purposes. Certainly, many items whose characterization as property cannot be contested produce only ordinary income when sold.

If the argument is as stated in the last paragraph, it brings a very difficult capital gain issue into the very difficult AMT arena, making the AMT arena even more difficult. Just why capital gain lore, a thorny thicket, should be mixed with the AMT is unclear. The only apparent reason for mixing capital gain doctrine with the AMT is to prevent characterization of the taxpayer's causes of action as property and thus to refute *Amicus*'s argument, below, that the rules on acquisition and disposition of property apply to these causes of actions. If those rules do not apply, so Petitioner may argue, the AMT applies to taxpayers' acquisition and disposition of their tort claims. There is no other demonstrable benefit.

B. The Undisputed Treatment of Transaction Costs

Once the taxpayers' tort claims are properly characterized as property, a entire new vista for tax treatment opens up.[12] It is that the legal fees are transaction costs, and it has been with us since the beginning of the income tax. What is that vista? It is that the legal fees are transaction costs, and transaction costs are not deductible. Section 263; Reg. § 1.263(a)-1(b) and Reg. § 1.263(a)-2(e).[13] Instead, transaction

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[11] That question is not before the Court. Time enough to deal with it if it should arise. *Amicus* doubts that it will arise. The case cited by *Amici* would then be relevant.

[12] Logically, there is little reason to limit the doctrine of capitalization of transaction costs, to property. Rather, a properly defined transaction would be the limitation, but *Amicus* does not in this brief argue for application of the doctrine beyond an item properly characterized as property.

[13] Reg. refers to regulations issued under the Internal Revenue Code of 1986 unless otherwise defined.

costs related to the acquisition and disposition of property are offset against the recovery they produce. Only the remaining amount is included in income.

If the transaction is an acquisition, costs are added to the basis of the acquired property. *True, Jr. v. United States*, 894 F.2d 1197 (10th Cir. 1990) and Revenue Rulings 69-561, 1969-2 C.B. 25 and 68-528, 1968-2 C.B. 331. If the transaction costs are related to the disposition of property, they are subtracted from the proceeds of the disposition with only the remaining amount being realized as income.[14] *Helvering* v. *Union Pacific*, 293 U.S. 282 (1934, *reh. denied* 293 U.S. 630 (1934) and *Spreckels v. Commissioner*, 315 U.S. 626 (1942). This treatment of transaction costs has been undisputed in the 91 years that the income tax has been with us. Generally, this disallowance of deduction is, and will in this brief sometimes be, called the capitalization doctrine. The Court dealt with it extensively in *INDOPCO, Inc. v. Commissioner, supra.*

This treatment is predicated on statutory language that, in 1913, appeared and still today appears to deal only with the acquisition costs. Section II,(B), *sixth,* Act of 1913, 38 Stat. 114, disallowed deductions for "any amount paid out for new buildings, permanent improvements, or betterments, made to increase the value of any property or estate." Substantially, the same language is found in section 263(a)(1) of the Internal Revenue Code of 1986. Despite the apparent limitation to

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[14] The Internal Revenue Service has been a bit wobbly whether the transaction costs offset the proceeds directly or are first added to basis and then subtracted as basis from the proceeds to reach the amount of income to be reported by the taxpayer. *Compare*, for example, IRS Publication 523, page 3 (offset to proceeds) to IRS Publication 544, page 4, and Regulation § 15a.453-1(b)(2)(v) (included as an addition to basis). *See also Kirschenmann v. Commissioner,* 488 F.2d 270 (1973), where the IRS unsuccessfully contested the addition of selling expenses to basis but argued that they should reduce the amount realized. For present purposes, either technique is acceptable.

acquisitions, it is applied both to acquisition costs and disposition costs. *True, Jr. v. United States, supra, Helvering v. Union Pacific*, 293 U.S. 282 (1934), *supra*, and *Spreckels v. Commissioner, supra.*

Application of this doctrine to the instant cases means that the legal fees are not deductions. Rather, they are transaction costs subtracted from the litigation or settlement proceeds received by the taxpayers. Only the amount left over is included in income. The alternative minimum tax is not implicated because there are no deductions to be disallowed by sections 56(b)(1)(A).

These rules for acquisition and sales of property may be demonstrated by an example, here explained in terms of the purchase and sale of real estate rather than tort claims because *Amicus* believes that Petitioner will not dispute application of these rules to real estate. The example will explain the difference between treating transaction costs as subject to capitalization (*Amicus*'s theory) and the deduction of transaction costs (Petitioner's position).

Suppose A buys a parcel of land for $900. A also pays a lawyer for negotiation of the purchase and incurs recording and title insurance costs. Together the legal fees and other payments are transaction costs, and assume that they total $100. They are not deductible. Rather, A must capitalize both the $900 purchase price and the $100 of transaction costs. A gets a basis of $1,000 for the total of the purchase price and the transaction costs. Suppose that A sells the parcel for $1,500. Assume also that A hired a real estate broker to make the sale and a lawyer to close the transaction. Suppose that the broker was paid $90 and the lawyer $60. These items total to $150, and they are transaction costs under the law. When A calculates profit, A will reduce the $1,500 price received by the $1,000 cost plus the $150 of transaction cost incurred on the sale. A will have gross income of only $350 (whether characterized as capital gain or ordinary income). This result accords with the economics of the

transaction. A is ahead by $350, and that is what A is taxed on. These results are undisputable under present law, and the result is not changed if A is subject to the AMT.

Amicus believes that Petitioner and *Amici* would agree about the acquisition costs and that A would have a basis of $1,000 for the parcel of land. Their theory, which *Amicus* believes they would not apply to real estate but do apply to taxpayers' tort claims, would not allow the disposition costs to offset the proceeds of sale. Rather, when the parcel is sold for $1,500, the basis would be subtracted, and A would have $500 of gross income. If the property produces capital gain, A will have a capital gain of $500. Under the regular tax, A would be allowed to deduct the $150 of transaction costs against any income that A had, but this deduction would not be allowed for AMT purposes. Under the AMT, if Petitioner and *Amici* are right, A would have $500 of income although A is ahead economically by only $350.

The law indisputably requires capitalization of transactions costs on voluntary sales of property and also on involuntary sales. *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995). Also, on injuries to property. *Inaja Land Co. v. Commissioner*, 9 T.C. 727 (1947). The question posed by the cases at bar are whether these clear, uncontested rules for transaction costs should be applied to Respondents' causes of action or whether the transaction costs are to be converted to deductions. If that occurs, the deductions will be disallowed under the AMT, and Respondents will be subject to tax on much more than they gained economically from the lawsuits.

C. The Legal Fees in These Cases Are Transaction Costs

The legal fees in the cases at bar are either acquisition costs, disposition costs, or both. The taxpayers had a right, created either by common law or by statute, violated by tortious conduct. Legal fees were incurred to establish the violation of a right, to show the extent of the damage, and

finally to settle on the amount due the taxpayers. These fees were costs. They are directly traceable to a discrete, recognizable transaction. The fees were necessary to the acquisition of property, the causes of action, and the lawyers' services disposed of this property by obtaining payment from the defendants in the civil lawsuits.

The most recent definition of acquisition costs state that an expenditure is a cost if it facilitates a transaction. Reg. § 1.263(a)-4(e)(1).[15] Certainly, the legal fees in question here facilitated the acquisition and disposition of the causes of action. Typically, an expenditure becomes an expense rather than a transaction cost if it is an indirect cost that cannot be traced to a specific transaction but rather might have enabled a number of different transactions and produced a number of different benefits.[16]

The legal fees in the present cases are very similar to those incurred in *Baylin v. United States, supra*. In *Baylin*, Mr. Baylin had property taken by the State of Maryland. He was unable to contest the taking of the property, just as the taxpayers in these cases were unable to contest the damage inflicted upon, and both the taxpayers and Mr. Baylin were left to post-injury damages. When the State did not offer what Mr. Baylin thought was sufficient, he went to court and contested the amount. He prevailed and recovered a much

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[15] These regulations do not deal with disposition costs and cannot be expected to define a disposition cost. One supposes amounts paid to facilitate a disposition would be treated as transaction costs because that treatment is consistent with the long history of the income tax and the regulations on acquisitions.

[16] For example, the IRS has issued a number of regulations related to indirect costs of inventories, and in 1986, the Congress required indirect costs to be capitalized as a part of the costs of property in accordance with section 263A. Section 803 of the Tax Reform Act of 1986, P.L. 99-514. These prior regulations can be found at Reg. § 1.471-3, T.D. 6336, Nov. 25, 1958, and T.D. 6500, Nov. 9, 1960, amended by the T.D. 7285, and Reg. § 1.471-11, T.D. 7285, Sept. 14, 1973.

larger sum than the State had offered. His legal fees were subtracted from the award from the State, and he was taxed upon the proceeds reduced by the legal fees. So clear is the result[17] in *Baylin* that the Petitioner's and *Amici*'s citation[18] of it as supporting them is inexplicable.

In *Alexander v. IRS*, 72 F.3d 938 (1995), cited by both Petitioner and *Amici* as supporting their positions, the Court of Appeals for the First Circuit did not allow a taxpayer to offset legal fees against a settlement. The court did not adopt the analysis made here, but one circuit court opinion should not be dispositive of one issue.

The similarity of these cases to the taking of property in *Baylin v. United States*, *supra*, argues strongly for application to the cases at bar of the well-developed rules applied in *Baylin v. United States, supra*. There is no articulated reason for not applying *Baylin*.

D. The Disallowance of Deductions for Transaction Costs Has Several Merits

Transactions cost are properly disallowed as deductions. Disallowance of deductions produces a matching of cost against its associated income. Matching of income and cost is an important doctrine of income taxation and a fundamental principle of accounting. Matching prevents the separation of costs and income for the benefit of either taxpayers or the government. The capitalization doctrine also can prevent transaction costs related to the earning of capital gain income from being deducted against ordinary income.[19] By the

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[17] The court in *Baylin* said: "The IRS classified all of the legal fees as a capital expenditure and calculated a capital gain . . . by adding all of the legal fees to the basis of the condemned property. . ." at page 1453.

[18] *See* Petitioner's brief at page 23 and *Amici*'s brief at page 3.

[19] *See* the example in text above.

capitalization doctrine, transaction costs are given the same character as the income earned by them.

The administrative convenience is important if the statute does not demand inconvenience, and as argued in the pages below, it does not in these cases. Under the capitalization doctrine both taxpayers and the government have their burdens minimized. They do not have to determine whether transaction costs are deductions falling into itemized deductions and allowed only if they exceed the standard deduction. Or whether they constitute business or nonbusiness deductions. Or, for that matter, get into the determinations made in these cases.

Neither Petitioner nor *Amici* have argued that they reach a proper economic result. They must acknowledge that under their theory, after application of the AMT, taxpayers will be taxed on amounts far greater than their economic income - sometimes, even to the point that the taxpayers' costs and taxes exceed the amount of the recovery. That their results are harsh is not, of course, an argument against them if that is what the statute requires. But Petitioner cannot point to any language in the statute (either the AMT provisions or sections 162 and 212) that mandate Petitioner's results. Nothing in the literature (whether committee or conference report, academic or professional journals, or learned treatises) surrounding either the passage of section 162 (business deductions, enacted as a part of the first income statute in 1913), section 212 (investment deductions, first enacted as section 23(a)(2) of the Internal Revenue Code of 1939 by section 121(a) of the Revenue Act of 1942) or sections 55-59 (the alternative minimum tax) vaguely suggests that the results pressed by Petitioner and *Amici* were perceived by a single member of the Congresses that have passed and later amended these provisions. Lack of support in the literature, of course, would not be harmful to their theory if their theory were required by the statutory language of any of the provisions just cited. But it is not, and in the absence of statutory language specifying

the results urged by Petitioner and *Amici*, this paucity of materials in the literature is telling in the face of what the Congresses must have known: Transactions costs are not deductions. There is no indication that any member of any of these Congresses ever thought that enactment of section 162, section 212, or the AMT changed the capitalization rule.

The language of the statute (sections 55-59, 162, and 212) does not demand the harsh result urged by Petitioner and *Amici*. Rather, an appropriate result taxing the taxpayer only on economic gain can be reached within the wording of the statute, and that result is consistent with tax doctrine that was reached under the original income tax act and that has prevailed since.

E. Simultaneity of Acquisition and Disposition Does Not Change Rules for Transaction Costs

This *Amicus* also thinks that Petitioner may argue that capitalization does not apply when disposition of property is almost simultaneous with its acquisition. Petitioner may argue that *INDOPCO* does not apply to cases with benefits so evanescent. While *INDOPCO* speaks of disallowing deductions for amounts paid for future benefits, the opinion is grounded on the premise that purchases of property are not deductible expenses. Analytically, the cases before the Court involve an acquisition of property through showing of an injury, a valuing of the property, and finally a disposition of the property through judgment or settlement. Each of these steps can be thought of as a separate transaction with each step having its costs capitalized. But the steps in these cases are compressed into a single moment. This compression gives no good reason for changing the rules applicable to each step. If this Court were to hold that this compression somehow makes capitalization inapposite, taxpayers sufficiently advised will effectively have an election. Separate the steps and have capitalization apply; compress the steps and have the yet-to-be-announced rule apply. The simultaneity of the acquisition, valuing, and disposition

provides no justification for this election. The compressed steps should remain subject to capitalization.

Under *INDOPCO* all expenditures are presumptively capital in nature. The simultaneity of the acquisition of a valid cause of action and its disposition should not change the *INDOPCO* presumption and transform capital expenditures into deductions. The character of expenditures should not turn on the order and timing of incurrence and disposition.

Amicus thinks that reply briefs may possibly question the application of the capitalization doctrine by arguing that drawing a line between transaction costs and deductions will be difficult and that the Court should not introduce that kind of uncertainty into the tax law. This difficulty is avoided, so the argument may run, by treating all expenditures as deductions. *Amicus* responds that doctrine should not be so cavalierly overridden. There is no uncertainty in the instant cases. This Court's opinion upholding *Amicus* position would not introduce uncertainty. The Court would simply be hewing to a line between transactions costs and deductions that already exists for the very important reasons set out above.

II. Petitioner's Reliance on Cases of Gratuitous Assignments of Income Is Improper[20]

A. The Assignments in These Cases Are Not Gratuitous Assignments

In its argument that taxpayers should include all of the recoveries in income, Petitioner relies on venerable, reliable, and still authoritative (except to the extent changed by subsequent statutes) opinions of the Court. The seminal case was *Lucas v. Earl*, 281 U. S. 11 (1930). In 1901, well before the enactment of the income tax in 1913, Mr. Earl assigned

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[20] The Petitioner is correct that the tax treatment of legal fees is a matter of federal law. It should not vary from state to state. Treating legal fees as transaction costs will achieve this national uniformity and obviate the difficult analyses made by the courts below.

one-half of all of his subsequent earnings to his wife. After enactment of the income tax, Mrs. Earl paid, and Mr. Earl did not pay, tax on the earnings she received under the assignment. In a progressive income tax, the Earls' splitting of income reduced the overall tax. This treatment was challenged by the government. It argued that Mr. Earl could not avoid taxation on his earnings by giving them away to a family member. The Court agreed. Subsequently, in *Helvering v. Horst*, 311 U.S. 112 (1940), this doctrine was applied to interest income on a corporate bond that Mr. Horst gave to his son.

These holdings were necessary to prevent evisceration of the income tax through intra-family arrangements that arbitrarily sought to shift income from family member to family member in accordance with need or the tax brackets of the donor and the recipient without substantially changing the net wealth or income of the family as a whole.

The assignments of income in the cases before the Court are quite different. They were made for consideration. Each party bargained to obtain the best deal available. Self-interest on each end of the bargain gives quite a different cast to the rules that are applied.

Here is how these well-developed rules apply to assignments for consideration. The assignor (taxpayers in these cases) is taxed on the receipt of consideration. If the consideration cannot be valued when the assignment is made, taxation is deferred until it can be valued. Once the consideration is valued and included in income, the assignor receives a basis for the consideration. This basis is equal to the value of the consideration received. The assignee is taxed on the assigned income.[21] These rules are appropriate for the

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[21] These rules have produced some difficulty when the assigned interest is a carved-out interest. *See for example*, sections 167(e), 636, 1001(e), 1286, and 7872(b), and *Hort* v. *Commissioner*, *supra* note 10, or *Commissioner v. P.G. Lake, Inc.*, *supra* note 10. But these statutory

cases at bar. The negotiation between a client and a lawyer do not produce gratuitous assignments. Rather, the client's assignment of a part of the prospective recovery is for value - the lawyer's promise to advocate the client's case.

The inclusion in income of the value of the services gives the client a basis for the legal services, and the services and the basis given them have in turn been expended in obtaining the balance of the settlement or judgment.[22] This is unexceptional income tax doctrine. It should be applied to the assignments in the cases at bar.[23]

B. Petitioner's Recent Rulings Contradict Petitioner's Position

Petitioner's argument about assignments of income is maintained in this Court despite two recent rulings that flatly

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enactments have not changed the rules except as provided by the statutes, and few would argue that either *Hort* or *Commissioner v. P.G. Lake, Inc.* is wrongly decided. *Estate of Stranahan*, 472 F.2d 867 (6th Cir. 1973), also presented a carved-out interest with consideration in a friendly, family situation. In cases at hand, the interest assigned is not a carved-out interest but a vertical slice of the entire package of future income. If one might make an analogy to gratuitous assignments by saying that carved-out assignments are the *Earl*, *supra*, and *Horst*, *supra*, cases while the vertical slice is *Blair v. Commissioner*, 300 U.S. 5, 57 S.Ct. 330, 81 L.Ed. 465 (1937). This is not to suggest that the gratuitous rules apply but that a dichotomy between carve-outs and vertical slices arises in commercial assignments as well as gratuitous assignments.

[22] We should not be troubled that the client may under some circumstances take it all back by firing the lawyer. If that occurs, the process starts over once again when a new lawyer is hired. This revocability might lay the basis for an argument that the assignment is a carve-out. But the assignment is no longer revocable when value can be ascertained, and, for present purposes, there is little difference between carve-outs and vertical slices. Note 21, *supra*, suggests that commercial carve-outs have required legislation to prevent manipulation. One could hardly argue that manipulation would be less with the rules for gratuitous assignments.

[23] Cf. Brief of the *Amici*, pages 7-13.

contradict Petitioner's position in this Court. In private letter ruling 200344022 issued July 24, 2003, (and released to the public on October 31, 2003), the IRS ruled that plaintiffs in a class action lawsuit did not realize the amount of the legal fees paid to counsel. The IRS reasoned that because the plaintiffs had no contract with the lawyers, the fees were not included in the plaintiffs' income. If this Court upholds the IRS in the cases at bar, the distinction arising from this private letter ruling will encourage class action lawsuits. It would also, apparently, distinguish between the plaintiff hiring the lawyers in a class action suit (who have a contractual relationship with the lawyers) and other plaintiffs, who also benefit from the lawyer's services. If this Court upholds the IRS in the present cases, plaintiffs with the initiative to hire lawyers will be subject to tax under the AMT, but the more supine, less aggressive plaintiffs who lie back to benefit from the class action will be exempted from the AMT.

In private letter ruling 200427009 (issued March 19, 2004, just a few days before certiorari was granted in these cases and released to the public on July 2, 2004), the IRS ambivalence about its position in this Court is even more apparent. The taxpayer, in this ruling, a plaintiff in a lawsuit, while recovery was still contingent on successful prosecution of the action, assigned a portion of a recovery, if any, to a second party in return for the second party's foregoing claims against the plaintiff. The IRS said that the portion of the settlement paid the second party was not included in the plaintiff's income as long as "recovery on such claim is doubtful or contingent" at the time of the agreement with the second party. Petitioner cannot, *Amicus* suggests, square this ruling with its argument in this Court.

III. The *Amici Curiae* Brief of Professors Polsky and Hellwig

Most of the analysis in this brief does not differ from or is not in conflict with that made by *Amici*. Divergence occurs only on the question whether the amounts paid to taxpayers'

lawyers were transaction costs or deductions. In support of their argument that the expenditures were deductions, *Amici* point out that section 83(h) allows a deduction under IRC section 162 for amounts subject to section 83. They go on to assert that the sharing of the proceeds of the litigation with the lawyers is subject to section 83 and thus the language of sections 83(h) makes the legal fees deductions. They do not point out that the deduction allowed by section 83(h) is subject to the capitalization doctrine just as deductions under sections 162 and 212 are.

This result is made explicit by Reg. § 1.83-6(a)(4) which prohibits a deduction for a capital expenditure. This prohibition is consistent with *INDOPCO*, the overriding of sections 162 and 212 by section 263, and the analysis in this brief.

IV. Conclusion

The legal fees in these cases are transaction costs, not expenses. The line between a transaction cost and an expense is not always easy to find, but in these cases it is bright. Transaction costs are expenditures that facilitate the transaction. Reg. § 1.263(a)-4(e)(1). The legal fees at issue were incurred to value the rights taken from taxpayers and then to dispose of the taxpayers' causes of action arising from tortious behavior. That is very similar to the taking and valuing of the property in *Baylin v. United States, supra*. The legal fees were not deductible in that case, and they are not in these cases. They are transaction costs directly traceable to proceeds, and they should be offset against the proceeds in accordance with established income tax doctrine—as old as the income tax itself.

Only expenses are subject to disallowance under the AMT, and the legal fees subject of this proceeding are not expenses.

The judgments of the Sixth and Ninth Circuits should be remanded for proceedings consistent with the Court's opinion treating the legal fees as transaction costs, not as deductions.

Respectfully Submitted,

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August 2004

APPENDIX

IRC § 56(b) Adjustments applicable to individuals. —

In determining the amount of the alternative minimum taxable income of any taxpayer (other than a corporation), the following treatment shall apply (in lieu of the treatment applicable for purposes of computing the regular tax:

(1) Limitation on deductions
(A) In general
No deduction shall be allowed. —

(i) for any miscellaneous itemized deduction (as defined in section 67(b)) . . . .

* * *

IRC § 67(b) Miscellaneous itemized deductions. —

For the purposes of this section, the term "miscellaneous itemized deductions" means the itemized deductions other than —

[There follows a list of exceptions not relevant to these cases.]

IRC § 162(a) In general. — There shall be allowed as a deduction all of the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . .

* * *

I.R.C. § 197(d) — Section 197 intangible. —
For purposes of this section —

(1) In general

Except as otherwise provided in this section, the term "section 197 intangible" means —

(A) goodwill,

(B) going concern value,

(C) any of the following intangible items:

(i) work force in place including its composition and terms and conditions (contractual or otherwise) of its employment,

(ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),

(iii) any patent, copyright, formula, process, design, pattern, know-how, format, or other similar item,

(iv) any customer-based intangible,

(v) any supplier-based intangible, and

(vi) any other similar item,

(D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,

(E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and

(F) any franchise, trademark, or trade name.

(2) Customer-based intangible

(A) In general

The term "customer-based intangible" means —

(i) composition of market,

(ii) market share, and

(iii) any other value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers.

(B) Special rule for financial institutions

In the case of a financial institution, the term "customer-based intangible" includes deposit base and similar items.

(3) Supplier-based intangible

The term "supplier-based intangible" means any value resulting from future acquisitions of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or sold by the taxpayer.

* * *

IRC § 212 Expenses for the production of income. — In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year —

(1) for the production or collection of income;

(2) for the management, conservation, or maintenance of property held for the production of income; or. . .

I.R.C. § 263 — Capital expenditures

(a) General rule

No deduction shall be allowed for —

(1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate.

* * *

Treas. Reg. § 1.263(a)-1(b) — In general, the amounts referred to in paragraph (a) of this section include amounts paid or

incurred (1) to add to the value, or substantially prolong the useful life, of property owned by the taxpayer, such as plant or equipment, or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures within the meaning of subparagraphs (1) and (2) of this paragraph . . . . Capital expenditures are subsequently recovered through depreciation, amortization, cost of goods sold, as an adjustment to basis, or otherwise, at such time as the property to which the amount relates is used, sold, or otherwise disposed of by the taxpayer, in accordance with applicable code sections and guidance published by the secretary.

Treas. Reg. § 1.263(a)-2(e) — Commissions paid in purchasing securities. Commissions paid in selling securities are an offset against the selling price, except that in the case of dealers in securities such commissions may be treated as an ordinary and necessary business expense.

Treas. Reg. § 1.263(a)-4(e)(1) — Scope of facilitate —

(i) In general.

Except as otherwise provided in this section, an amount is paid to facilitate the acquisition or creation of an intangible (the transaction) if the amount is paid in the process of investigating or otherwise pursuing the transaction. Whether an amount is paid in the process of investigating or otherwise pursuing the transaction is determined based on all of the facts and circumstances. In determining whether an amount is paid to facilitate a transaction, the fact that the amount would (or would not) have been paid but for the transaction is relevant, but is not determinative. An amount paid to determine the value or price of an intangible is an amount paid in the process of investigating or otherwise pursuing the transaction.

Treas. Reg. § 15a.453-1(b)(2)(v) — Gross profit defined.

. . . For sales in taxable years ending after October 19, 1980, in the case of sales of real property by a person other than a dealer and casual sales of personal property, commissions and other selling expenses shall be added to basis for purposes of determining the proportion of payments which is gross profit attributable to the disposition. . . .

Nos. 03-892 and 03-907

AUG 18 2004

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v.

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Respondent.

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v.

SIGITAS J. BANAITIS,
Respondent.

On Writs of Certiorari to the United States Court of Appeals for the Sixth and Ninth Circuits

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BRIEF *AMICUS CURIAE* OF THE EQUAL EMPLOYMENT ADVISORY COUNCIL IN SUPPORT OF RESPONDENTS

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BRIEF *AMICUS CURIAE* OF THE EQUAL EMPLOYMENT ADVISORY COUNCIL IN SUPPORT OF RESPONDENTS

The Equal Employment Advisory Council respectfully submits this brief *amicus curiae* in support of Respondents John W. Banks, II and Sigitas J. Banaitis.[1] Written consent of all parties has been filed with the Clerk of the Court.

[1] Counsel for *amicus curiae* authored this brief in its entirety. No person or entity, other than the *amicus curiae*, its members, or its counsel, made a monetary contribution to the preparation of the brief.

INTEREST OF THE *AMICUS CURIAE*

The Equal Employment Advisory Council (EEAC) is a nationwide association of employers organized in 1976 to promote sound approaches to eliminating discriminatory employment practices. Its membership comprises over 330 of the nation's largest private sector corporations. EEAC's directors and officers include many of industry's leading experts in the field of equal employment opportunity. Their combined experience gives EEAC an unmatched knowledge of the practical, as well as legal ramifications of equal employment opportunity policies and requirements. EEAC's members are firmly committed to the principles of nondiscrimination and equal employment opportunity.

All of EEAC's members are employers subject to Title VII of the Civil Rights Act of 1964, 42 U.S.C. §§ 2000e *et seq.*, the Age Discrimination in Employment Act of 1967 (ADEA), 29 U.S.C. §§ 621 *et seq.*, Titles I and V of the Americans with Disabilities Act (ADA), 42 U.S.C. §§ 12101 *et seq.*, the Family and Medical Leave Act (FMLA), 29 U.S.C. §§ 2601 *et seq.*, and other employment-related statutes and regulations. As employers, as potential targets of employment discrimination charges and lawsuits, and as the ultimate sources of funds for the payment of settlements and verdicts in these cases, EEAC's members have a substantial interest in the issue presented for the Court's consideration in this case—*i.e.*, whether the portion of the proceeds of litigation that is paid to a plaintiff's attorney pursuant to a contingent fee agreement is part of that plaintiff's taxable gross income.

EEAC members' interest in this issue is rooted in important, practical concerns. The Court's decision will have a direct and substantial impact on the ability of parties to settle employment discrimination claims. The extent of tax liability has an absolute bearing on the amount of money that the plaintiff ultimately will take home. Since the plaintiff's attorney also will pay income taxes on the portion he or she

receives, making this portion taxable to the plaintiff as well results in double taxation, upping the tax liability and concomitantly raising the amount a plaintiff will need to seek in settlement negotiations in order to take home the desired bottom line. The employers either will be paying the bill, or will decline to settle, so that the ultimate impact will be on the already overburdened federal court system.

Because of its concerns, EEAC over the years has filed *amicus curiae* briefs addressing the issue of taxation of damages in employment law cases.[2] In short, EEAC has a substantial interest in, and familiarity with, the issues and policy concerns presented to the Court in this case. Because of its experience in these matters, EEAC is well-suited to brief the Court on implications of the issues extending beyond the immediate concerns of the parties.

STATEMENT OF THE CASE

No. 03-892. Respondent John W. Banks, II, sued his former employer for employment discrimination under Title VII, 42 U.S.C. § 1981, and state law. Pet. App. 2a. During trial in 1990, the parties settled for $464,000, of which Banks paid $150,000 to his attorneys according to their contingent fee agreement. Pet. App. 4a-5a. Banks did not include any of the settlement in his gross income for 1990. Pet. App. 5a. The Internal Revenue Service (IRS) issued a deficiency notice, and Banks petitioned the U.S. Tax Court for a redetermination. Pet. App. 6a.

Among other things, the Tax Court ruled that the $150,000 contingent fee was taxable income to Banks. Pet. App. 7a. He appealed to the Sixth Circuit. The Sixth Circuit reversed, holding that the portion of a settlement paid to a plaintiff's

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[2] *E.g.*, *Commissioner v. Schleier*, 515 U.S. 323 (1995); *United States v. Burke*, 504 U.S. 229 (1992).

attorney as a contingent fee was not income to the plaintiff. Pet. App. 25a.

No. 03-907. Respondent Sigitas J. Banaitis filed a wrongful discharge case against the Bank of California, his former employer, and Mitsubishi Bank, which owned a controlling interest in the Bank of California. He was represented by attorneys pursuant to a contingent fee agreement. Pet. App. 3a-4a. After trial, the jury awarded him backpay, front pay, and compensatory and punitive damages. Pet. App. 5a. The trial court set aside the punitive damages award and both parties appealed. Banaitis and his lawyers revised their contingent fee agreement, raising the percentage to be paid to the lawyers if successful. *Id.* Near the end of a lengthy appeals process, the parties settled the case. Pet. App. 6a. Mitsubishi Bank cut a check payable to Banaitis, and the Bank of California cut a check payable directly to his lawyers. *Id.* After Banaitis reported only his part of the settlement on his tax return, the IRS issued a deficiency notice, concluding that the amount paid to Banaitis' lawyers was taxable income to him. Pet. App. 7a. The Tax Court agreed, and Banaitis appealed to the Ninth Circuit. Pet. App. 8a. The Ninth Circuit concluded that Oregon law provides an attorney with a lien on a judgment or settlement, and that as a result, the money paid to Banaitis' lawyers was not includable in his gross income. Pet. App. 12a-16a.

The Commissioner of Internal Revenue, represented by the Solicitor General of the United States, petitioned this Court for writs of *certiorari* in both cases. The Court granted both petitions and consolidated the cases for oral argument.

SUMMARY OF ARGUMENT

The Sixth and Ninth Circuits below reached the right conclusion, that the portion of a damages recovery paid to the plaintiff's attorney pursuant to a contingent fee agreement is

not taxable income to the plaintiff. No. 03-892, Pet. App. 25a; No. 03-907, Pet. App. 12a-16a. Although they reached this result using different reasoning, either approach is correct. Before a settlement or verdict, an attorney's fee is only a hope, at most an undefined expectation. Once the settlement or verdict occurs, the proceeds belong in part to the attorney who earned them and the client on whose behalf they were earned, whether dictated by state law, as the Ninth Circuit ruled, or by the nature of the contingency fee, as the Sixth Circuit concluded.

As a practical matter, double taxation of the attorney's contingent fee ratchets up the cost of potential settlements, to the ultimate detriment of plaintiffs, defendant employers, and the courts. Contrary to the Commissioner's argument, this situation indeed *is* double taxation, since two taxpayers are being taxed on the same receipts at the same time. Where the government seeks an extra helping, the plaintiff's counsel has to seek more money in negotiating a settlement in order to bring home the same bottom line. As a result, the potential cost of settlement increases for the employer—who may or may not decide to make the business judgment to hand over the additional funds. If the employer declines, the parties' only remaining choice is to litigate, raising the burden on the plaintiff, the employer, and ultimately, the courts.

ARGUMENT

I. THE SIXTH AND NINTH CIRCUITS RULED CORRECTLY THAT THE PORTION OF A DAMAGES RECOVERY PAID TO A TAXPAYER'S ATTORNEY PURSUANT TO A CONTINGENT FEE AGREEMENT IS NOT INCLUDED IN GROSS INCOME

In each case below, the Court of Appeals properly ruled that the portion of the monetary settlement of a taxpayer's lawsuit against his employer that is paid to his attorney

pursuant to a contingent fee agreement should not be included in the taxpayer's gross income.[3] In *Banaitis*, the Ninth Circuit recognized that state law can vest an attorney with a property interest by virtue of the contingent fee agreement "that cannot be extinguished or discharged by the parties to the action except by payment to the attorney." Pet. App. 16a. In such a case, the Ninth Circuit ruled, the portion of the proceeds of the lawsuit that are payable to the attorney are not includable in the taxpayer's gross income. While it previously had ruled in other cases that contingent fees could be included in gross income, the Ninth Circuit distinguished those cases by highlighting the absence of any state-created property interest. Pet. App. 13a.

The Sixth Circuit approached the analysis from a different direction in *Banks*. While recognizing that a state-created property right can shift title to the attorney's portion of settlement proceeds sufficiently to prevent it from being income to the taxpayer, the Sixth Circuit concluded, as had the Fifth Circuit in *Srivastava v. Commisioner*, 220 F.3d 353, 363-64 (5th Cir. 2000), that the issue did not turn on the presence, absence, or precise language of a state attorney's lien law. Pet. App. 23a. Indeed, the Sixth Circuit reasoned, using a state-by-state approach would offer consistency to neither the court nor to taxpayers. Pet. App. 24a.

Rather, the Sixth Circuit concluded that the *nature* of a contingency fee makes it inappropriate to include that amount in the taxpayer's gross income, based on its previous ruling in *Estate of Clarks ex rel. Brisco-Whitter v. United States*, 202 F.3d 854, 856 (6th Cir. 2000). There, the Sixth Circuit readily distinguished the contingency fee situation from this Court's decisions in *Lucas v. Earl*, 281 U.S. 111 (1930) (holding that fees and salary earned by a taxpayer were not

[3] As outlined in both Petitions, several other courts of appeals have disagreed. E.g., *Kenseth v. Commissioner*, 259 F.3d 881 (7th Cir. 2001).

rendered taxable only by half by virtue of a contract he had entered into with his wife in which they agreed that any property, income and the like would be held as joint tenants), and *Helvering v. Horst*, 311 U.S. 112 (1940) (holding that a taxpayer's gift of negotiable interest coupons from negotiable bonds to his son, who collected the interest later in the year when they matured, constituted the realization of taxable income to the taxpayer). Unlike those cases, the Sixth Circuit explained:

> (1) the fact that the claim, at the time the contingency fee agreement was signed, was 'an intangible, contingent expectancy,' (2) taxpayer's claim was like a partnership or joint venture in which the taxpayer assigned away one-third in hope of recovering two-thirds; (3) no tax-avoidance purpose was at work with the contingency-fee arrangement, as there ostensibly was in *Lucas* and *Horst*, and (4) double taxation would otherwise result by including the contingency fee in taxpayer's income.

Pet. App. 24a (summarizing *Estate of Clarks*, 202 F.3d at 857-58).

Either analysis leads correctly to the conclusion that a plaintiff's attorney's contingent fee is not taxable to the client. Before any recovery is realized, a contingent fee agreement constitutes only a hope of income to the attorney, to be realized only if the attorney's labors result in income to the client. Once there is a settlement or verdict, the proceeds belong in part to the client, on whose behalf they were obtained, and in part to the attorney who obtained them, in an amount established by the contingent fee agreement. Where state law so provides, the portion of the proceeds attributable to the contingent fee in effect is the property of the attorney from the beginning, as the Ninth Circuit ruled. Even absent such a state law, the Sixth Circuit's reasoning—that "[t]he income should be charged to the one who earned it and received it," *Estate of Clarks*, 202 F.3d at 858, is sound.

II. DOUBLE TAXATION OF THE PROCEEDS IN EMPLOYMENT LITIGATION RATCHETS UP THE COST OF SETTLEMENTS, POTENTIALLY INCREASING THE BURDENS OF LITIGATION ON LITIGANTS AND THE COURT SYSTEM

Important public policy considerations also support excluding an attorney's contingent fee from the client's gross income. Double taxation by the government increases the cost of settlements, making them ultimately less likely, to the ultimate detriment of the court system.

A. Taxing the Portion of a Settlement That Represents a Contingent Fee Is Double Taxation, Since Both the Plaintiff and the Plaintiffs' Attorney Will Pay Tax on the Same Dollars Obtained at the Same Time

A contingent fee received by a plaintiff's attorney is, of course, taxable earned income to that attorney. Under the Commissioner's position, some or all of that contingent fee is also taxable to the plaintiff, even though he or she is likely never to see or touch it. The Commissioner's view, that this is somehow *not* double taxation, is erroneous.

While the Internal Revenue Code does allow a successful plaintiff to claim the attorney's fee as a miscellaneous itemized deduction on his or her personal income tax return, 26 U.S.C. § 212, several other provisions limit or even eliminate the extent to which the plaintiff can actually take the deduction. Under 26 U.S.C. § 67, miscellaneous itemized deductions are permitted only to the extent that they exceed 2% of the taxpayer's adjusted gross income. On the other end, 26 U.S.C. § 68 places a cap on itemized deductions for any taxpayer whose adjusted gross income exceeds an

inflation-adjusted "applicable amount,"[4] reducing itemized deductions by 3% of the excess up to a maximum reduction of 80% of itemized deductions.

Moreover, the alternative minimum tax (AMT), 26 U.S.C. § 55, also is likely to affect, if not eliminate, a plaintiff's ability to deduct his attorney's fees from taxable income. "A significant miscellaneous deduction for attorney's fees will often trigger a significant AMT and, thereby, effectively reduce or eliminate the deduction." Jonathan Samel, *Courts Differ on Taxation of Contingent Attorney's Fees: Should the Internal Revenue Service Collect on the Full Amount of a Client Settlement?*, 166 N.J.L.J. 193, 196 (Oct. 15, 2001).

The Commissioner sees no incongruity in getting a double tax dip from the attorney's contingent fee—once from the plaintiff, who likely will never even see it, and also from the attorney, who will pay taxes on the fee as earned income. According to the Government, "double taxation" is quite common, *e.g.*, if an individual earns money at his job and uses it to pay for the services of a plumber, the Internal Revenue Service collects income taxes from both. Brief of the Commissioner at 34.

The Commissioner's example, however, actually illustrates the difference, not the similarity, between the two situations. Where a taxpayer earns income and elects to use it to purchase the services of a plumber, the taxpayer's initial receipt of wages is not dependent upon—or even related to—the fact that he will someday hire a plumber. Rather, the taxpayer's receipt of earned income depends on the terms and conditions of the taxpayer's own employment, the hours he works and the wages he earns. Nor is a portion of the

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[4] The "applicable amount" was $139,500 for 2003. IRS, Tax Law Changes for Individuals, Tax Year 2003, Limit on Itemized Deductions, *available at* http://www.irs.gov/formspubs/article/0,,id=109876,00.html#item_ded_2003

taxpayer's paycheck committed in advance to the plumber, or contingent in any way on the degree of success of the plumber's work.

Here, in contrast, the taxpayer's receipt of funds is tied inextricably to the attorney's work. The attorney will receive a fee only if he or she succeeds in obtaining a monetary settlement or judgment for the taxpayer, and the taxpayer likewise will receive a settlement only if the attorney is successful.

Moreover, unlike a taxpayer who cashes a paycheck and uses some of his earnings to buy a plumber's services, the taxpayer-plaintiff may never even see, much less touch, the contingent fee portion of the settlement proceeds. If the attorney's fee is paid to the attorney by one check, and the balance due the plaintiff in another, the fee will never even have passed through the plaintiff's hands. Similarly, if the check for the entire proceeds is made payable to the attorney alone, for appropriate disbursement, the plaintiff will never have seen the portion representing the attorney's contingent fee. Even where there is a single check, payable to both the plaintiff and his attorney, the plaintiff is likely to catch only a fleeting glimpse of the full amount as he endorses the check before it is whisked into his attorney's escrow account for distribution. Nevertheless, in either case, the employer is required to report the full amount, including the fee, to the IRS on a Form 1099, even though the plaintiff barely touched it if at all. 26 C.F.R. § 1.6041-1(f).[5] Since the fee is taxable income to both the plaintiff and the attorney, the Commis-

[5] Some employers may be unaware of this requirement, since IRS training materials say that "a Form 1099 is not usually issued to the plaintiff" and suggest that IRS employees comb newspaper articles and courthouse dockets to root out settlements in which the government has not received its share. IRS, Market Segment Specialization Program Guideline, Lawsuit Awards and Settlements, Nov. 2000, *available at* 2000 WL 33171823, at *22.

sioner's interpretation *does* amount to double taxation of the same dollars.

B. Double Taxation of Part of the Settlement Proceeds Inhibits Settlements by Increasing the Cost

The government's insistence on its extra helping has a direct negative practical effect on the settlement of lawsuits, and ultimately, on the already tightly stretched court system. Having to include yet an additional portion for the government in calculating an appropriate settlement demand escalates the plaintiff's counsel's negotiating demand, and raises the stakes for the employer, who may or may not want to pay the additional increment to settle. If not, another jury trial is added to the federal courts' already teeming dockets.

About seventy percent of the lawsuits filed in federal court, including those dealing with employment-related issues, are terminated by settlement. Clermont, Kevin J. & Stewart J. Schwab, *How Employment Discrimination Plaintiffs Fare in Federal Court*, 1 J. Empirical Legal Stud. 429, 440, July 2004. Indeed, Congress passed the Alternative Dispute Resolution Act (ADRA), Pub. L. 105-315, 28 U.S.C. §§ 651–658, in 1998, authorizing the federal courts to use alternative dispute resolution methods, including mediation and other forms of facilitated settlement, in lieu of trial to resolve cases. Obviously, settlements of lawsuits that otherwise would have to be tried substantially reduce the burdens facing the federal courts today. Indeed, with more than a quarter of a million civil cases filed in federal district courts every year[6], any

[6] Administrative Office of the United States Courts, Table C, U.S. District Courts—Civil Cases Commenced, Terminated, and Pending During the 12-Month Periods Ending December 31, 2000-2003, *available at* http://www.uscourts.gov/library/statisticsalreports.html (Federal Judicial Caseload Statistics 2001, 2002 & 2003).

significant impediment to settlement necessarily will increase the courts' workload substantially.

The double taxation that the Commissioner's position demands is just such an impediment. By requiring plaintiffs and plaintiffs' counsel to pay income tax on the same dollars, the Commissioner's view sets aside an extra helping of each settlement—in addition to those portions already taxable to the plaintiff (such as backpay, and compensatory and punitive damages), IRS Bulletin No. 1996-53, Rev. Rul. 96-65 (Dec. 30, 1996), at 5-6,[7] and to the plaintiff's counsel (the attorney's fee) as a windfall to the government. Absent any other source, the Government's extra bite comes directly from the plaintiff's share.

The net result is an increase in the amount each plaintiff and his or her counsel will seek to negotiate from the defendant employer to resolve the case. In order to take the same amount home, the plaintiff will have to get more from the employer. Indeed, lawyers have warned each other that ignorance of the tax implications of a settlement can have dire consequences, turning a good result into a bad one. Steven I. Adler *et al.*, *Taxation Without Representation: If Tax Implications Are Not Considered When Resolving Employment Claims, A Good Settlement or Judgment Could Turn Sour*, 167 N.J.L.J. 1288 (Mar. 25, 2002).

Thus, in order to reach the same net result, plaintiffs' counsel necessarily must start with a higher settlement demand than they would absent the double taxation problem.

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[7] 26 U.S.C. § 104(a)(2), which lists deductions allowed for compensation for injuries or sickness, exempts "the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal *physical* injuries or physical sickness;" and thus makes compensatory damages for emotional distress non-excludable from gross income "except to the extent they are damages paid for medical care . . . attributable to emotional distress." Rev. Rul. 96-65, at 6 (emphasis added).

Likewise, if the case indeed is going to settle, they must negotiate from the employer a larger amount. Employers then have two choices—pay the higher amount, or litigate. If the plaintiff's minimum threshold is more than the employer is willing to pay, litigation becomes the only option and another amicable settlement is thwarted.

Double taxation of the contingent fee thus increases the burdens on both litigants and the court system. By boosting the gross cost of settlements to cover the government's double dip, plaintiffs have to ask for more to get the same amount, employers have to pay more if they want to settle, and the courts feel the pinch if the increased cost dooms settlement.

CONCLUSION

For the foregoing reasons, the *amicus curiae* Equal Employment Advisory Council respectfully submits that the decisions below should be affirmed.

Respectfully submitted,

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IN THE

Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

JOHN W. BANKS, II,

Respondent.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

SIGITAS J. BANAITIS,

Respondent.

On Writs of Certiorari to the United States Courts of Appeals for the Sixth and Ninth Circuits

BRIEF OF KENNETH W. GIDEON, MAXINE AARONSON, GAIL RICHMOND, AND MONA L. HYMEL AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF *AMICI CURIAE*

Kenneth W. Gideon, Maxine Aaronson, Gail Richmond, and Mona L. Hymel are tax attorneys who have advised clients, made continuing legal education and bar presentations, or written on the tax treatment of contingent attorney's fees over many years. Gail Richmond and Mona L. Hymel are tax professors.[1]

SUMMARY OF ARGUMENT

Under the position espoused by the United States in the two cases before the Court, a recovery of nominal damages (say $1) together with an award of substantial attorney's fees (say $275,000) by an unmarried plaintiff who successfully vindicates an important right justifying the award of such fees will result in that plaintiff receiving a tax bill from the Internal Revenue Service for not less than $73,500, despite the fact that the only amount received by the plaintiff was a single dollar.[2] The plaintiff's attorneys

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[1] Pursuant to this Court's Rule 37.3(a), letters of consent from all parties to the filing of this brief have been filed with the Clerk. Pursuant to this Court's Rule 37.6, *amici* state that this brief was not authored in whole or in part by counsel for any party. No person other than the *amici* has made a monetary contribution to the preparation or submission of this brief.

[2] Although attorney's fees are deductible for regular income tax purposes under either 26 U.S.C. § 162 (ordinary and necessary business expenses) or § 212 (expenses for the production of income), neither employee business expenses nor § 212 deductions are allowed for purposes of the alternative minimum tax imposed by 26 U.S.C. § 55. On the facts stated above, if fees received by the plaintiff's attorney are also included in the plaintiff's income (as the Government contends), the tax imposed would be at least $73,500 ($275,001 gross income x 26% tax rate on the first $175,000 and 28% on any additional amount per § 55(b)(1)(A)(i)(I)). If attorney's fees of the magnitude set forth in the example are included in the plaintiff's income, any exemption provided by § 55(d)(1)(B) would be fully phased out. 26 U.S.C. § 55(d)(3)(B).

will receive (and also be taxed) on the $275,000 in awarded fees. Imposing a tax bill of $73,500 on a single dollar of disposable income cannot be defended on policy grounds, nor can it plausibly be contended that so anomalous a result was "intended" by Congress.

The possibility that a successful plaintiff would owe the Government more in taxes than the plaintiff recovers is not a mere hypothetical possibility under the Government's position.[3] The actual facts of the *Banaitis* case illustrate the anomaly of the Government's position as well. Although the maximum individual income tax rate enacted by Congress in 26 U.S.C. § 1 is currently 35 percent, the effective rates of tax on the amounts actually paid to Mr. Banaitis and Mr. Banks are well in excess of the 35 percent rate. *Banaitis v. Commissioner*, 340 F.3d 1074, 1078 (9th Cir. 2003); *Banks v. Commissioner*, 345 F.3d 373, 376-77 (6th Cir. 2003).

This result, the Government argues, is compelled by the Internal Revenue Code and the assignment of income doctrine set forth in this Court's decisions in *Lucas v. Earl*, 281 U.S. 111 (1930) ("*Earl*") and *Helvering v. Horst*, 311 U.S. 112 (1940) ("*Horst*"). Neither case requires the result the Government seeks. No Code provision demonstrates any intention by Congress to tax litigants as the Government contends.

The assignment of income doctrine is an anti-abuse rule devised by this Court to prevent inappropriate income shifting among family members or other related persons. In

[3] *See* Adam Liptak, *Tax Bill Exceeds Award to Officer in Sex Bias Suit*, N.Y. Times, Aug. 11, 2002, at A12, reporting the case of a Chicago police officer who recovered an award for sex discrimination and harassment of $300,000 and attorney's fees of more than $1,000,000 with the result that her tax bill consumed her entire $300,000 award and left her owing the Internal Revenue Service more than $99,000 in taxes.

contrast to *Earl* and *Horst*, there is no taxpayer "abuse" in the cases at bar. They involve the most common form of funding of individual tort litigation – contingent fees – not an artificial shifting of income designed to defeat the income tax laws.[4] These cases represent an effort by the Government to impose an irrationally high and highly variable level of tax burden on successful plaintiffs. The exact rate depends on the fees payable to a plaintiff's attorney rather than the amount received by or under the dominion and control of the taxpayer. There is no Congressional mandate to tax the same income to plaintiffs as well as to their attorneys.

The assignment of income doctrine emerging from *Earl* and *Horst* is the judiciary's creation, not an enactment of Congress. It is not a constitutional principle or immutable "super law." In the court decisions that have adopted the Government's position that the assignment of income doctrine should be extended to reach contingent fees, the authors of the decisions have described the result as one that "smacks of injustice," is "unfortunate" and has a "potential for unfairness." *See, e.g.*, *Alexander v. IRS*, 72 F.3d 938, 946 (1st Cir. 1995); *Raymond v. United States*, 355 F.3d 107, 115 (2d Cir. 2004); *Kenseth v. Commissioner*, 114 T.C. 399, 407 (2000), *aff'd*, 259 F.3d 881 (7th Cir. 2001). It is the duty of this Court, as the author of the assignment of income doctrine, to correct that doctrine's erroneous application to these circumstances.

[4] The plaintiffs and the attorneys in the two cases before the Court are not related. Nor is there any suggestion that the contingent fees paid in either case are anything other than arm's length transactions. In contrast, both *Earl* and *Horst* involved intrafamily gifts.

ARGUMENT

I. THE INTERNAL REVENUE CODE CONTAINS NO PROVISION REQUIRING THAT A CONTINGENT FEE PAID TO THE ATTORNEY FOR A SUCCESSFUL PLAINTIFF BE TAXABLE TO BOTH THE PLAINTIFF AND THE ATTORNEY

The question in this case depends upon whether a plaintiff is taxable on an amount paid to the plaintiff's attorney under either a contingent fee contract (providing that a percentage of any recovery will be payable to the plaintiff's attorney) or under a statutory provision authorizing recovery of attorney's fees as well as damages.[5] In its brief, the Government identifies no provision of the Code that requires that such fees be taxed as if they were first income to the plaintiff and then taxed again to the attorney, and there is none.[6]

Instead, the Government relies on cases such as *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955) (holding that antitrust treble damages were taxable) and

[5] *See, e.g.*, 42 U.S.C. § 2000e-5(k) (providing for attorney's fees under the Civil Rights Act of 1964).

[6] Congress has limited the deductibility of attorney's fees incurred as employee business expenses (*i.e.*, fees incurred without granting the attorney any share in any ultimate recovery) for purposes of the regular tax, 26 U.S.C. §§ 62(a)(2) and 67, and denied the deduction altogether for purposes of the alternative minimum tax, 26 U.S.C. §§ 55-56. Those situations differ from the contingent fee arrangements in which the plaintiff cannot exercise dominion and control over the amount received by the attorney. The statutory language imposing deduction limitations on employee business expenses discloses no Congressional intention to tax plaintiffs on fees paid to their attorneys under contingent fee arrangements.

Commissioner v. Schleier, 515 U.S. 323 (1995) (holding that age discrimination recoveries were not compensation for personal injuries) for the proposition that 26 U.S.C. § 61(a) exercises "the full measure of [Congress'] taxing power" and taxes "all gains except those specifically exempted." (Petitioner's Brief at 15.)

The question is not whether the attorney's fee is gross income; the question is whose gross income is it? Attorney's fees (from the perspective of a plaintiff as opposed to an attorney) do not meet the *Glenshaw Glass* standard of "undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." 348 U.S. at 431. Regardless of the vagaries of state attorney's lien laws,[7] all such laws provide that once a properly executed contingent fee contract is in place (and the attorney performs the services required under the contract), the attorney, not the litigant, enjoys the wealth embodied in the fee, realizes that amount, and has complete dominion over it. As this Court observed long after the decisions in *Earl* and *Horst*,

> We know of no decision of this Court wherein a person has been found to have taxable income that he did not receive and that he was prohibited from receiving . . . . The underlying assumption always has been

[7] While the Government errs in attempting to attribute fees earned by and belonging to the attorney in a contingent fee case to the plaintiff, it is correct that the consequences of such contingency fee arrangements should not depend on subtle variations in state lien law. Under all the states' attorney lien laws, the plaintiff cannot exercise dominion or control over the portion of any recovery payable to the plaintiff's attorney under a contingent fee contract absent the attorney's malfeasance or failure to perform. It is this core reality that should govern the Federal tax consequences of contingent fee and statutory attorney's fee cases, not the variations in each state's law.

> that in order to be taxed for income, a taxpayer must have complete dominion over it.

Commissioner v. First Sec. Bank, 405 U.S. 394, 403 (1972).[8]

II. THE ASSIGNMENT OF INCOME DOCTRINE DOES NOT REQUIRE THAT A PLAINTIFF BE TAXED ON INCOME HE DID NOT EARN AND CAN NEVER RECEIVE OR CONTROL

Earl dealt with an individual's effort to assign one-half of his salary to his wife for reasons unrelated to the income tax. (Indeed, the assignment in 1901 was made long before the income tax was enacted.) As the *Earl* Court noted, performance of the services giving rise to the taxpayer's salary could not "be taken by anyone but himself alone." 281 U.S. at 114. By contrast, litigants engage attorneys precisely because they themselves lack the ability to successfully pursue their claim without the assistance of a person trained in the law and skilled in legal matters. As the Sixth Circuit recognized in *Banks*, 345 F.3d at 384, the

[8] The Government cites *Helvering v. Clifford*, 309 U.S. 331, 338 (1940), but that case did not reach the assignment of income doctrine. The Court found the settlor's dominion over the income and corpus in a family trust situation was so little disturbed by the purported assignment to other family members that it was ineffective for income tax purposes. In *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729-31 (1929), also cited by the Government, this Court held that an employer's payment of the income tax on an employee's salary constituted additional taxable income to the employee. Unlike this case, there was no issue there as to whether the income on which the tax payment was predicated was properly taxable to the employee; it was the employee's salary which could not be attributed to the efforts of any other person. *Old Colony Trust* thus does not reach the question of whether contingent fees or statutory attorney's fees are includible in a plaintiff's income and does not provide a precedent for such inclusion.

taxpayers were "dependent upon the attorney's skills to realize any value from [their claims]." *Horst* involved a gift of bond coupons for periodic interest payments by a father to a son while the father retained the bond itself (and the right to principal repayment the bond itself represented).[9] *Horst* recognized that its conclusion (that the interest income remained taxable to the father) was dependent upon the conclusion that the father was the person "who earn[ed] or otherwise create[d] the right to receive it and enjoy the benefit of it when paid." 311 U.S. at 119.

Had either of the taxpayers in *Earl* or *Horst* succeeded in transferring the tax on income earned by the donor to relatives in lower tax brackets, the progressive income tax rate structure as enacted by Congress would have been circumvented. As in another of this Court's landmark anti-abuse decisions of the same era, *Gregory v. Helvering*, 293 U.S. 465, 469 (1935), the assignments attempted in *Earl* and *Horst* did not comport with Congressional intent. Consistency with the reasoning of *Gregory*, however, requires that the Government likewise be forbidden to achieve unintended and unjust results based on essentially technical arguments.

While it is undoubtedly true that "income is taxed to the person who earned it" (Petitioner's Brief at 14), the Government errs in asserting that Mr. Banks and Mr.

[9] Both *Earl* and *Horst* have been displaced on their specific facts by subsequent statutory provisions crafted by Congress to address the issues in those cases. Thus, Congress has provided a different rate schedule for married taxpayers filing joint returns in 26 U.S.C. § 1(a) to address (at least to some degree) the difference in taxation between taxation of income earned by married taxpayers in separate property and community property states. The income taxation of stripped bond coupons at issue in *Horst* is now governed by 26 U.S.C. § 1286 and would now differ substantially from the result reached in *Horst*.

Banaitis "would have been required to include the entire taxable proceeds from those courses of action in their gross income if the proceeds had been paid directly to them." (Petitioner's Brief at 16; *see also id.* at 24.) Tax consequences do not turn on the formalities of how funds are transferred, but on the economic rights of the parties in those funds and the substance of the transactions. For example, under 26 U.S.C. § 482 and the regulations thereunder dealing with related party transactions, taxable income is allocable to the taxpayer who bears the risks, exercises functional control, and has the contractual responsibility and duty to perform services, not the one who received a payment in the first instance. Treas. Reg. § 1.482-1(d)(1).

Prior to the filing of any lawsuit, the plaintiffs here, by executing contingent fee contracts, separated themselves from any dominion or control over the amounts that would ultimately become payable to their attorneys in the event of a recovery. At the time those contracts were entered into, there was no certainty that the plaintiffs would recover any amount, and the amounts recovered were clearly dependent upon the skill and efforts of their attorneys.[10] Unlike the

[10] In Private Letter Ruling 200427009 (July 2, 2004), the Internal Revenue Service held that a plaintiff's partial allocation of a claim against an insurer to a third party (in consideration for the third party's forgoing certain claims against the plaintiff) did not constitute an assignment of income. In the ruling, the Internal Revenue Service stated that "in general, a transferor who makes an effective transfer of a claim in litigation to a third person prior to the time of the expiration of appeals in the case is not required to include the proceeds of the judgment in income under the assignment of income doctrine because such claims are contingent and doubtful in nature." The ruling held specifically that the assignment of income doctrine did not apply. By application of similar analysis in this case, an allocation of a portion of a claim to an attorney as a contingent fee would result in the fee being gross income only to the attorney. No portion would be income to the plaintiff. Under 26 U.S.C. § 6110(k)(3), such rulings may not be relied on as precedent; however, this Court has cited such rulings where the analysis in the ruling was pertinent to the issue before the Court. *See, e.g., Rowan Cos. v. United States*, 452 U.S. 247, 261 n.17 (1981); *Hanover Bank v. Commissioner*, 369 U.S. 672, 686-87 (1962).

salary in *Earl* or the bond coupon in *Horst*, there was no certainty that any amount could be collected. The active involvement and effort of plaintiffs' attorneys were required to bring the recoveries about. The plaintiffs here could not generate their recoveries by their efforts or capital alone.

Referring to a contingency fee arrangement, the Sixth Circuit in *Estate of Clarks v. United States*, 202 F.3d 854, 857-58 (6th Cir. 2000) stated, "[t]he present transaction . . . is more like a division of property than an assignment of income" because "the value of taxpayer's lawsuit was entirely speculative and dependent on the services of counsel." The Sixth Circuit recognized this fact in *Banks*, stating that "a contingency fee, as part of a litigation claim, was not already earned, vested, or even relatively certain to be paid to the assignor, but instead was merely 'an intangible, contingent expectancy,' dependent upon the attorney's skills to realize any value from it." 345 F.3d at 384 (citation omitted).

In support of its argument that attorney's fees under a contingent fee contract or statutory award are taxable to both the plaintiff and the attorney who earned them, the Government, citing the Seventh Circuit's decision in *Kenseth v. Commissioner*, 259 F.3d 881, 883 (7th Cir. 2001), contends that failure to attribute the amount payable as a contingent attorney's fee to the plaintiff would unfairly distinguish contingent fees from attorney's fees determined on an hourly basis. (Petitioner's Brief at 24; *see also id.* at 31.) But the hourly-fee-paying plaintiff gives up nothing with respect to any part of any judgment or settlement ultimately received. Such a plaintiff may dismiss one

attorney at will and hire another because the attorney has no right of any kind in the recovery and does not share the risk of loss or the reward of success. Indeed, at some later point in the litigation, such a plaintiff may choose to enter into a contingent fee contract if the payment of hourly fees proves too onerous. In contrast, a plaintiff who has entered into a contingent fee arrangement cannot divest a performing attorney of the attorney's right to a specified portion of the ultimate award and has restricted abilities to terminate the attorney.

The argument that parity between contingent fee payors and hourly fee payors is desirable as a "neutral principle" cannot justify the draconian results of the Government's position. Indeed, the Government's position will prevent some plaintiffs from vindicating important legal rights for fear that any monetary award will be insufficient to cover the tax assessed on the plaintiff for the contingent fee paid to the attorney.[11]

Admittedly, the client in a contingent fee arrangement typically retains two rights: the right to dismiss the lawsuit (and thus preclude any recovery) and the right to approve any settlement (*i.e.*, the attorney cannot settle the plaintiff's lawsuit without the plaintiff's consent). But neither of these rights differs from the rights a co-venturer or co-owner may exercise without being treated as "earning" the share of income accruing to the other venturer or owner.

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[11] *See, e.g., City of Riverside v. Rivera*, 477 U.S. 561, 577-78 (1986) (recognizing that "'[F]ee awards have proved an essential remedy if private citizens are to have a meaningful opportunity to vindicate the important Congressional policies which these laws contain.'" (citation omitted)); *Deposit Guar. Nat'l Bank v. Roper*, 445 U.S. 326, 338 (1980) (recognizing the important role contingent fee arrangements have "played in vindicating the rights of individuals who otherwise might not consider it worth the candle to embark on litigation . . . .").

These legal relationships have long been recognized by the Government as being outside the assignment of income doctrine.[12]

As *Earl* and *Horst* demonstrate, this Court adopted the assignment of income doctrine in the intrafamily context and has applied it in the context of assignments and transfers between related parties. *See, e.g., Commissioner v. Culbertson*, 337 U.S. 733 (1949) (applying doctrine in the context of intrafamily assignment); *United States v. Basye*, 410 U.S. 441 (1973) (applying doctrine in the context of assignments among a partnership and its partners); *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370 (1983) (applying doctrine in the context of assignments between a corporation and its shareholders). The extension of such a judge-made doctrine beyond the related party context in which it developed is simply not warranted in these cases and the result of such extension "smacks of injustice."[13]

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[12] It is well settled that co-owners are taxable only on their proportionate shares of the income received. *See Pearsall v. United States*, 52 F.2d 1050 (Ct. Cl. 1931) (undivided interest in exclusive sales agency for specialized iron products); *Ferry Market, Inc. v. Commissioner*, 5 B.T.A. 167 (1926) (fractional interest in steam schooner). In real estate ventures and crop share farming, all parties benefit from shared efforts in the same sense that a plaintiff benefits from an attorney's efforts, yet those co-venturers report only their own income share. They are not taxed on another party's income and then forced to deduct the third party's share as an expense for the production of income. *See Bartholomew v. Commissioner*, 10 T.C.M. (CCH) 957 (1951) (engineer who contributed services was joint venturer with investors in real estate project); *Podell v. Commissioner*, 55 T.C. 429 (1970) (attorney providing capital is joint venturer with real estate operator providing services).

[13] The Tax Court majority in *Kenseth* premised its adoption of the Government's position here on its perception of "dangers in the ad hoc modification of established tax law principles or doctrines [*i.e.*, the assignment of income doctrine] to counteract hardship in specific cases."

CONCLUSION

The Tax Court dissenters in *Kenseth v. Commissioner* had it right when they protested that:

> The [Tax Court] majority in the instant case tax to petitioners substantial funds that petitioners did not receive, were never entitled to receive, and never turned their backs on. They do so in the name of the assignment of income doctrine. The majority acknowledge that there may be injustice in so doing, and that the injustice may well be even greater in other real-life settings than in the instant case. They contend that precedents compel them to this result and that relief can come only from the hills (Psalm 121), or at least from Capitol Hill. But this Court has shown . . . that reexamination of the origins of the assignment of income doctrine can sharpen our understanding of the concepts and make more rational the application of that doctrine. We do not lightly overrule our prior decisions. But when experience and analysis show that we have departed from the origins that we once thought to be the foundations of

Kenseth, 114 T.C. at 407. However, neither the Government in its brief nor any of the courts that have adopted the Government's position have articulated what those "dangers" might be. Indeed, respecting unrelated parties' allocation of income in a contingent fee context just as they are respected in partnerships, sharecropping situations and other co-venturer arrangements poses no such "danger." Thus, ruling that the assignment of income doctrine does not apply here is not an "ad hoc modification of established tax law principles," but rather an opportunity for this Court to prevent an unjust and erroneous expansion of the assignment of income doctrine and to clarify that the doctrine is not applicable in the contingent fee context where there are no related parties.

> those decisions, and when it is our judicial interpretations and not the statute law that lead to results that increasingly seem to be unjust, then we ought to reexamine the foundations of the doctrine.

114 T.C. at 420-21 (citations omitted).

This Court should not permit the assignment of income doctrine, a judicially crafted anti-abuse rule, to become itself a source of abuse and injustice. Indeed, a refocusing on the basis for the assignment of income doctrine would be completely consistent with Justice Holmes' admonition in *Earl* that the decision should turn "on the import and reasonable construction of the taxing act," 281 U.S. at 114, and with Justice Stone's pronouncement in *Horst* that "[c]ommon understanding and experience are the touchstones for the interpretation of the revenue laws," 311 U.S. at 118. Taxing plaintiffs on income they can never receive or control and which their attorneys, not they, have earned, defies both "common understanding and experience" and is not a "reasonable construction" of the Internal Revenue Code.

This Court should affirm both judgments and hold that the taxpayers are not taxable on contingent fees that

were paid to their attorneys and over which they had no dominion or control.

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vs.
JOHN W. BANKS, II, *Respondent*.

COMMISSIONER OF INTERNAL REVENUE, *Petitioner*,
vs.
SIGITAS J. BANAITIS, *Respondent*.

On Writs of Certiorari to the United States Courts of Appeals for the Sixth and Ninth Circuits

BRIEF *AMICI CURIAE* OF THE LAWYERS' COMMITTEE FOR CIVIL RIGHTS UNDER LAW, THE BAZELON CENTER FOR MENTAL HEALTH LAW, THE NATIONAL ASIAN PACIFIC AMERICAN LEGAL CONSORTIUM, THE NATIONAL ASSOCIATION FOR THE ADVANCEMENT OF COLORED PEOPLE, THE NATIONAL ASSOCIATION OF PROTECTION AND ADVOCACY SYSTEMS, AND THE NATIONAL WOMEN'S LAW CENTER IN SUPPORT OF RESPONDENTS

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INTEREST OF *AMICI CURIAE*

The Lawyers' Committee for Civil Rights Under Law, The Bazelon Center for Mental Health Law, the National Asian Pacific American Legal Consortium, the National Association for the Advancement of Colored People, the National Association of Protection and Advocacy Systems, and the National Women's Law Center submit this Brief as *amici curiae* with the consent of the parties,[1] in support of respondents' argument that a taxpayer's gross income under section 61(a) of the Internal Revenue Code does not include the portion of a litigation or settlement recovery that is paid to his attorneys pursuant to a contingent fee agreement.

These civil rights *amici* submit this brief because of the impact a ruling on this issue will have on victims of unlawful discrimination. The ability to obtain experienced legal counsel is a key component of a victim's right to be free from unlawful discrimination in our society. To the extent that the victim is required to pay taxes on the full amount of a contingent fee recovery in civil rights cases, the cost of settlement is driven up, the concept of "make whole" relief underlying many of the civil rights laws is undermined, and there could well be a chilling effect on a victim's interest in even obtaining counsel in civil rights cases. The people served by the *amici* will be directly affected by this Court's ruling in this matter.

The Lawyers' Committee for Civil Rights Under Law (the "Lawyers' Committee") is a nonprofit civil rights

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[1] Counsel for *amici curiae* authored this brief in its entirety. No person or entity other than *amici curiae*, their staffs, or their counsel made a monetary contribution to the preparation or submission of this brief. Letters of consent to the filing of this brief have been filed with the Clerk of the Court pursuant to Supreme Court Rule 37.3.

organization that was formed in 1963 at the request of President Kennedy in order to involve private attorneys throughout the country in the national effort to insure the civil rights of all Americans. Its Board of Trustees includes several past Presidents of the American Bar Association, past Attorneys General of the United States, law school deans and professors and many of the nation's leading lawyers. Through the Lawyers' Committee and its independent local affiliates, hundreds of attorneys have represented thousands of clients in civil rights cases across the country. The Lawyers' Committee is interested in ensuring that the goal of civil rights legislation, to eradicate discrimination, is fully realized, and is concerned in this case with the potential negative impact on a plaintiff's ability to obtain full and proper relief for valid civil rights claims. The resolution of this case will have a significant effect on the extent to which the Lawyers' Committee can protect the rights of its clients.

The Judge Bazelon Center for Mental Health Law is a national public interest organization founded in 1972 to advocate for the rights of individuals with mental disabilities. The Bazelon Center engages in litigation, administrative advocacy, and public education to promote equal opportunities for individuals with mental disabilities. In its litigation, the Bazelon Center frequently asserts claims under civil rights laws with fee-shifting provisions, such as the Americans with Disabilities Act and Section 504 of the Rehabilitation Act of 1973.

The National Asian Pacific American Legal Consortium ("NAPALC") is a national non-profit, non-partisan organization whose mission is to advance the legal and civil rights of Asian Pacific Americans. Collectively, NAPALC and its Affiliates, the Asian Law Caucus and the Asian Pacific American Legal Center of Southern California, have over 50 years of experience in providing legal public

policy, advocacy, and community education on discrimination issues. NAPALC and its Affiliates have a long-standing interest in civil rights issues that have an impact on the Asian Pacific American community, and this interest has resulted in NAPALC's participation in a number of amicus briefs before the courts.

The National Association for the Advancement of Colored People ("NAACP"), established in 1909, is the nation's oldest civil rights organization. The fundamental mission of the NAACP is the advancement and improvement of the political, educational, social, and economic status of minority groups; the elimination of prejudice; the publicizing of adverse effects of discrimination; and the initiation of lawful action to secure the elimination of age, racial, religious, and ethnic bias.

The Training and Advocacy Support Center of the National Association of Protection and Advocacy Systems ("TASC/NAPAS") provides training and technical assistance to the nationwide network of protection and advocacy ("P&A") agencies. Located in all 50 states, the District of Columbia, Puerto Rico, and the federal territories, P&As are mandated under various federal statutes to provide legal representation and related advocacy services on behalf of all persons with disabilities in a variety of settings. The P&A system comprises the nation's largest provider of legally based advocacy services for persons with disabilities. This case is of particular interest to TASC/NAPAS because the taxation of fees can have a chilling effect on individuals with disabilities who are trying to vindicate their rights, especially in cases seeking declaratory and injunctive relief.

The National Women's Law Center ("NWLC") is a non-profit legal advocacy organization dedicated to the advancement and protection of women's rights and the

corresponding elimination of sex discrimination from all facets of American life. Since 1972, NWLC has worked to secure equal opportunity for women in education, the workplace, and other settings, including through litigation of cases brought under federal anti-discrimination laws, often with the assistance of private attorneys. NWLC has a deep and abiding interest in insuring that these laws are fully implemented and enforced. NWLC is also the leading women's organization working on tax issues and has worked for more than 20 years to improve tax policies affecting women and their families.

SUMMARY OF ARGUMENT

Petitioner contends that respondents should be taxed on the full amount recovered on their claims. Petitioner argues that the parties' contingent fee arrangements involved the assignment of income by respondents to their lawyers in an amount equal to the lawyers' share of the recoveries. Under this Court's precedents, the argument runs, the income so assigned is properly taxed to respondents.

The assignment of income principle actually supports respondents, not petitioner. An assignment of income occurs when a taxpayer who expects to earn income, or who is already in control of income, assigns some or all of that income to another party who makes no contribution to the production of the income and therefore cannot be said to have earned it. In such situations, this Court has held that such income should be taxed to the assignor.

Here, at the time respondents entered into their negotiated, arm's length contingent fee agreements, they had no ability to know whether they would realize any income from their legal claims. The assistance of competent counsel was needed in order to convert the claims into income. Both

respondents (with their claims) and the lawyers (with their services) contributed to the production of the income realized. Each party earned, and should properly be taxed on, his respective share of the amount recovered.

There is no support for petitioner's additional argument that respondents realized income because their lawyers' fees were paid by the defendants directly out of the recoveries. This argument invokes the principle that a taxpayer realizes income when another party satisfies the taxpayer's obligation to a third party. Here, respondents had no personal obligations to their lawyers that could be satisfied when the legal fees were paid.

Because the division of proceeds contemplated by the contingent fee agreements did not involve an assignment of income by respondents and violated no other tax principles, the agreements should be respected for tax purposes. The lawyers were indisputably taxable on the fees they received. Respondents should not also be taxed on the same amounts.

A result in favor of petitioner here would not only be contrary to established tax principles; it would also directly undermine the concept of "make whole" relief embedded in our civil rights laws. Plaintiffs seeking to vindicate their civil rights might even be discouraged from retaining lawyers to assist them in their efforts. A contingent fee arrangement may be the only viable arrangement a plaintiff can enter into in many such cases. If petitioner prevails here, a victorious plaintiff in a contingent fee case might actually be worse off economically than if she took no action at all, because her alternative minimum tax liability on the full recovery might exceed the share of the recovery that she receives. Congress cannot have intended the tax laws to produce a result that would clash so directly with its intentions in the civil rights area.

If, notwithstanding the arguments made in favor of affirmance, this Court decides to reverse the decisions below on the ground that contingent legal fees should be taxed both to the successful plaintiffs and to the lawyers receiving them, this Court should make it clear that its decisions are not intended to apply to those cases in which the court awards reasonable attorney's fees to a prevailing plaintiff's counsel pursuant to a federal fee-shifting statute. Such statutory fees differ from contingent fees because Congress has determined the conditions under which they are payable and the court determines the amount to be paid.

ARGUMENT

I. The "Assignment of Income" Principle Supports Respondents, Not Petitioner.

Petitioner argues that the decisions below should be reversed because they failed to apply the "assignment of income" principle in a proper manner. According to petitioner, both cases involve a classic assignment of income by respondents to their lawyers in an amount equal to the lawyers' share of the recovery proceeds. Citing cases such as *Lucas* v. *Earl*, 281 U.S. 111 (1930), and *Helvering* v. *Horst*, 311 U.S. 112 (1940), petitioner contends that such assignments were ineffective to shift away from respondents the tax liability for the full amount recovered on their claims.

The instant cases are not classic assignment of income cases. The typical assignment of income cases generally fall into one of two categories – (1) a taxpayer intending to provide services for compensation assigns a portion of his anticipated compensation to another party, or (2) a taxpayer owning income-producing property assigns a portion of the anticipated income to another party. In the first category of cases, the taxpayer fully expects to earn the income being assigned. In the second category, the taxpayer

is already in control of the income. In both categories, the assignment is gratuitous and the assignee does not contribute in any way to the production of the income being assigned.

The precise issue presented in the assignment of income cases is which of the two parties – assignor or assignee – should be taxed on the income being assigned. In both categories of cases, this Court has held that the assignor should be taxed. *Lucas* v. *Earl*, 281 U.S. at 114-15; *Helvering* v. *Horst*, 311 U.S. at 147-49; *see also Commissioner* v. *Sunnen*, 333 U.S. 591, 609 (1948).

The basic principle established in those leading cases is that tax liability cannot be shifted by diverting to another party income that the taxpayer himself earns or controls. Under what is now section 61(a) of the Internal Revenue Code, Congress intended income to be taxed to the person who earns it (*Earl*, 281 U.S. at 114-15), or to the person who controls the property producing it (*Horst*, 311 U.S. at 166; *Sunnen*, 333 U.S. at 607). In the words of *Earl* and *Horst*, assigning to another party merely the fruit from a tree, but not the tree itself, will not be respected for tax purposes. *Compare Blair* v. *Commissioner*, 300 U.S. 5 (1937) (holding that the assignment of a beneficial interest in a trust was not an impermissible assignment of income).

A. Respondents and Their Lawyers Earned Their Respective Shares of the Recoveries.

The instant cases are completely different from the classic assignment of income cases. Under the principles established by this Court, they should be affirmed.

At the time respondents entered into their fee arrangements with their lawyers, they had no idea whether their claims could be converted into income. Competent legal representation was needed to realize whatever potential

value there may have been in the claims. A fee arrangement was agreed upon under which the lawyers would be paid a calculable amount, but only if there were a recovery and then only out of the proceeds of the recovery.

Under the contingent fee agreements, respondents retained the right to discharge their lawyers. In addition, a settlement could not be reached without their approval. Respondents thus reserved some control over the handling of their cases. Respondents may also have played a role in the cases by providing information and testimony, and by participating in strategic decisions. They were, however, in no position by themselves to control the outcome of the proceedings. Such recovery as they might enjoy would result from either a negotiated settlement or a favorable determination by a judge or jury, all of which required the involvement of their lawyers.

In terms of fees, respondents and their lawyers had a choice: they could have agreed on a fixed (or hourly) fee arrangement, or, as was done here, on a contingent fee arrangement. (Respondent in *Banks* (No. 03-892) brought his claims under federal statutes that permit the award of statutory legal fees by the court if the plaintiff prevails. The case was ultimately settled.)

In a fixed fee case, the lawyer is paid his fee by the claimant regardless of the outcome of the case. The lawyer has the possibility of earning a fee that exceeds the amount recovered, but he does not share the risk of an unfavorable result. In a fixed fee case, the claimant essentially states to the lawyer: "I will pay your fee no matter what the outcome. Whatever is recovered is mine."

In other words, in a fixed fee case the claimant and the lawyer plant separate trees and each enjoys (and must be taxed on) the fruit produced by his tree. The claimant is

therefore entitled to, and thus should be taxed on, the full amount of any recovery.

In a contingent fee case, the situation is completely different. The claimant and the lawyer agree to share the risk. In essence, they pool their resources. The claimant provides the capital (the claim) and the lawyer provides the labor (legal services). The lawyer will be compensated only if he produces a recovery, and then only out of the proceeds of such recovery. Unlike the situation in the fixed fee case, the lawyer's compensation is completely dependent on the outcome of the case. In a contingent fee case, the claimant essentially states to the lawyer: "I will not pay your fee. You will earn your fee out of what you are able to recover. The balance will be mine."

In other words, in a contingent fee case the claimant and the lawyer jointly agree to plant a single tree and share whatever fruit it may bear. Each therefore should be taxed only on his respective portion of any recovery.

Petitioner sees it differently. Petitioner asserts that even in contingent fee cases, the entire amount of the recovery should be taxed to the claimant. Since the lawyer is also taxed on his share of the proceeds, petitioner allows the claimant a miscellaneous itemized deduction for the amount so taxed to the lawyer. *See* 26 U.S.C. § 67(b). But such a deduction does not provide a dollar-for-dollar benefit in computing the claimant's taxable income and is not even taken into account in computing the claimant's alternative minimum tax liability. Petitioner's position thus has distinct adverse tax consequences to the claimant. *See* 26 U.S.C. § 67(a) (providing that miscellaneous itemized deductions are allowable only to the extent that the aggregate of such deductions exceeds two percent of adjusted gross income); 26 U.S.C. § 56(b)(1)(A)(i) (disallowing miscellaneous itemized deductions in computing the alternative minimum

tax). (The same adverse tax consequences may exist in a fixed fee case, but the successful contingent fee lawyer is likely to receive a larger fee than would his counterpart handling the same case on a fixed fee basis. The adverse tax consequences to the claimant are thus likely to be greater where contingent fees are involved.)

Petitioner either misunderstands or misapplies this Court's assignment of income principles. Petitioner ignores the fact that in *Lucas* v. *Earl*, Mrs. Earl made no contribution to her husband's earning of compensation for the services he rendered. 281 U.S. 113. Therefore, when Mrs. Earl reported one-half of her husband's income as hers, based solely on a prior arrangement under which Mr. Earl had agreed to have that portion of his income assigned to her, this Court ruled against her on the ground that Mr. Earl himself had earned all the income and was therefore the proper party to be taxed on it. Id. at 114-15.

In *Helvering* v. *Horst*, the interest coupons in question were attached to bonds that had been purchased by Mr. Horst. 311 U.S. 114. As the bond owner, Mr. Horst was the person entitled to cash in the coupons. Mr. Horst's son had made no contribution of any kind toward ownership of the bonds. He was not in control of the bonds and would not have been entitled to enjoy any income from them but for the gift made to him by his father. Accordingly, this Court held that the income from the coupons was properly taxable to Mr. Horst and not to his son. Id. at 120.

Here, by contrast, there would have been no income at all without the joint collaboration of respondents and their lawyers. Both parties clearly contributed to the production of the income realized when the recoveries were achieved. The instant cases therefore present something of a twist to the assignment of income issue.

In contrast to *Earl* and *Horst*, the instant cases go beyond the basic question whether the "assignor" or the "assignee" is the proper party to be taxed on a specific amount of income said to have been "assigned." The lawyers here clearly earned their respective shares of the recoveries and such amounts were properly taxable to them.

The instant cases raise the broader issue whether the amounts admittedly taxable to the "assignees" (the lawyers) should also simultaneously be taxed to the "assignors" (respondents). Did both parties simultaneously earn that portion of the recoveries? The assignment of income cases clearly do not address that issue.

As the Eighth Circuit succinctly stated in an early case: "The 'earner' of income is one whose personal efforts have produced it, who owns property which produced it or a combination of the two." *Van Meter* v. *Commissioner*, 61 F.2d 817, 817 (8th Cir. 1932). Here, both parties combined to earn the income in question. The arrangements they entered into were arm's length, commercial arrangements, not gratuitous arrangements designed to shift either respondent's tax burden in another direction. Because there was no assignment of income, the division of proceeds agreed to by the parties should be respected for tax purposes.

B. Respondents Had No Obligations To Their Lawyers That Were Satisfied By the Defendants' Payment of Their Legal Fees.

Perhaps recognizing the weakness in his assignment of income argument, petitioner also seeks support from this Court's decision in *Old Colony Trust Co.* v. *Commissioner*, 279 U.S. 716 (1929), which is not an assignment of income case. (Pet. Br. 19.) Again, however, petitioner is relying on inapposite authority.

Old Colony Trust involved the direct payment by an employer of its employee's tax obligations to the Government. This Court held that such payments, though not received by the employee, nevertheless constituted additional income to him, just as if they had been made to the employee so that he could pay the taxes himself.

The rule of *Old Colony Trust* is that if another party makes a payment to a third party to satisfy a taxpayer's obligation to the third party, the payment so made constitutes income to the taxpayer. Id. at 729-31. *Old Colony Trust* would be applicable here if respondents had incurred personal obligations to pay their lawyers' fees. In such a case, payment of such fees by the defendants, directly or indirectly, as part of the recoveries would have constituted income to respondents.

But those are not the facts here. Under respondents' contingent fee agreements, legal fees were payable only if a recovery were obtained and then only out of the recovery. Neither of the respondents had a personal obligation to pay the fees earned by the lawyers when the cases were finally resolved. As a result, payment of those fees by the defendants, directly or indirectly, could not have satisfied any obligations of respondents to their lawyers, because respondents had no obligations to their lawyers when the payments were made. Like *Lucas* v. *Earl* and *Helvering* v. *Horst*, *Old Colony Trust* has no application in contingent fee cases such as those now before this Court.

* * *

To summarize, in a fixed fee case, it is proper to tax the claimant on the entire recovery. That would be true whether the claimant receives the full amount or directs that part of it be paid to his lawyer. Because the lawyer's fee is not dependent on, or otherwise tied to the recovery, the

claimant has earned, and has complete dominion and control over, the entire amount recovered. He is therefore properly taxed on the full amount.

By contrast, in a contingent fee case, it is not proper to tax the claimant on the entire recovery. The claimant and the lawyer have pooled their resources and agreed to divide whatever results may be achieved. The lawyer's fee is solely dependent on, and is a specific portion of, the amount recovered. The claimant thus has not earned, and does not have complete dominion and control over, the entire recovery. He therefore cannot properly be taxed on the full amount.

Whether the parties choose a fixed fee arrangement or a contingent fee arrangement is a matter of arm's length negotiation. Some lawyers will only handle certain cases on a fixed fee basis; others will only handle the same cases on a contingent fee basis. Some claimants prefer a fixed fee arrangement. Other claimants may not have the funds to pay a fixed fee and can only proceed on a contingent fee basis. While the parties may consider the possible tax consequences to the claimant in reaching their agreement, many other considerations are likely to be of equal, if not more, importance.

Applying this Court's pronouncements to the situations here presented, it seems clear that respondents should be taxed only on their respective shares, and not on the full amount of the recoveries obtained.

II. Taxing the Plaintiff On the Attorney's Contingent Fee Is Inconsistent With the Purposes of Civil Rights Laws

In the experience of *amici*, plaintiffs in civil rights cases often enter into contingent fee agreements with private

attorneys because they do not have the funds to pay a fixed fee.[2] Thus, a large share of civil rights cases will be directly affected by the ruling in the instant cases. Taxing the plaintiff on the attorney's contingent fee would contradict not only established principles of the Internal Revenue Code, but also the express purpose of civil rights laws.

Specifically, such double taxation would undermine Congressional intent to provide "make whole" relief to victims of discrimination and to encourage settlements of civil rights cases. *See* Sager and Cohen, *How the Income Tax Undermines Civil Rights Law*, 73 S. Cal. L. Rev. 1075 (2000). Moreover, Congress has recognized that private lawsuits vindicate not only individual civil rights, but also the broader public interest in penalizing and deterring unlawful discrimination. *See* S. Rep. No. 1011, 94th Cong., 2d Sess. 2-3, *reprinted in* 1976 U.S.C.C.A.N. 5908, 5910. This Court has also recognized the public benefit of civil rights litigation. "Unlike most private tort litigants, a civil rights plaintiff seeks to vindicate important civil and constitutional rights that cannot be valued solely in monetary terms." *City of Riverside* v. *Rivera*, 477 U.S. 561, 574 (1986).

Taxing litigants on the contingent fees their lawyers receive could have a chilling effect on a plaintiff's interest in obtaining counsel to initiate a civil rights case, because a plaintiff subject to the alternative minimum tax could actually end up in a worse position economically by winning the case than by doing nothing. At a minimum, taxing litigants on contingent legal fees would drive up settlement costs, because plaintiffs would need more money to cover their tax obligations. The increased cost of settlements would undermine Congress' intent to promote conciliation of

[2] As noted earlier, attorneys' fees in certain civil rights cases may also be determined by statute.

civil rights cases. *See, e.g., Burlington Indus.* v. *Ellerth*, 524 U.S. 742, 764 (1998) (recognizing "Congress' intention to promote conciliation rather than litigation in the Title VII context").

Furthermore, as noted, the double taxation of attorney's fees would undermine the goal of providing "make whole" relief to victims of discrimination. *See, e.g., Albemarle Paper Co.* v. *Moody*, 422 U.S. 405, 419, 421 (1975) ("The 'make whole' purpose of Title VII is made evident by the legislative history. . . . Congress' purpose in vesting a variety of 'discretionary' powers in the courts was . . . to make possible the 'fashion[ing] [of] the most complete relief possible.'" (*quoting* 118 Cong. Rec. 7168 (1972)). The purpose of "make whole" relief is to "restore the victims of discriminatory conduct to the position they would have occupied in the absence of such conduct." *Milliken* v. *Bradley*, 418 U.S. 717, 746 (1974). If a successful plaintiff is required to pay taxes on the attorney's contingent fee, the plaintiff's net recovery will fall short of the express goal of "make whole" relief.

Surely Congress did not intend that the Internal Revenue Code would be construed so as to produce a result that undercuts the very objectives of its civil rights legislation.

III. The Statutory Fee Issue.

If, notwithstanding the arguments made in favor of affirmance, this Court decides to reverse the decisions below and hold that the contingent attorney's fees are taxable to both respondents and their lawyers, this Court's opinion should differentiate the instant cases from those involving statutory fees.

Statutory fee cases are different from contingent fee cases because, in a statutory fee case, the court decides on the amount of legal fees to be paid to plaintiff's counsel.[3] Under the statutory scheme, a prevailing plaintiff may petition the court for an order directing the defendant to pay the legal fees of the plaintiff's counsel. Statutory fees are nominally awarded by the court to the plaintiff, but in fact are intended for plaintiff's counsel. *See Kay* v. *Ehrler*, 499 U.S. 432 (1991) (stating that the purpose of fee-shifting statutes is "to enable potential plaintiffs to obtain the assistance of competent counsel in vindicating their rights," thus justifying denial of a statutory fee award to a plaintiff who, although a lawyer, appeared *pro se*). In some cases, statutory fees are paid to a non-profit entity organized under section 501(c)(3) of the Internal Revenue Code that has provided legal services to the plaintiff. *See* Brief of Mountain States Legal Foundation *et al*, as *Amici Curiae* in Support of Respondents. Settlements in statutory fee cases may also provide for legal fees.

Sometimes, the statutory fees awarded by the court can exceed the amount of the plaintiff's recovery. *See, e.g.*, *City of Riverside* v. *Rivera*, 477 U.S. at 581; *Porter* v. *Director, U.S. Agency for Int'l Dev.*, 293 F. Supp. 2d 152 (D.D.C. 2003). That is always true in the large number of statutory fee cases where only injunctive and declaratory relief is sought or available. *See, e.g.*, 42 U.S.C. 2000a-3 (authorizing actions only for injunctive relief against public accommodations discriminating on the basis of race); 42

[3] Statutory fees may be awarded by a court under numerous federal statutes which permit the award of attorney's fees to a prevailing party. *See, e.g.*, Fair Housing Amendments Act of 1988, 42 U.S.C. § 3613(c)(2); Americans with Disabilities Act, 42 U.S.C. § 12205; Equal Access to Justice Act, 28 U.S.C. § 2412(d)(1)(A); Civil Rights Attorney's Fees Awards Act of 1976, 42 U.S.C. § 1988(b); Civil Rights Act of 1964, 42 U.S.C. § 2000e-5(k).

U.S.C. § 12188(a) (same where discrimination is against persons with disabilities).

In contingent fee cases, the plaintiffs and their lawyers reach an arm's length agreement on how any recovery would be shared. In statutory fee cases, Congress has determined that the plaintiff's counsel should receive a reasonable fee if the plaintiff prevails, but the plaintiff has no control over the amount to be awarded. That decision is left entirely to the court.

As can be seen, there is a strong basis for concluding that the assignment of income doctrine and any other legal theories that might be considered supportive of petitioner's position in a contingent fee case would have no application in a statutory fee case. (For a full discussion of the reasons why attorney's fees obtained pursuant to a fee shifting statute do not constitute income to the claimant, *see* Brief of the National Employment Lawyers' Association, *et al*, as *Amici Curiae* in Support of Respondents.)

Because they frequently find themselves involved in statutory fee cases, *amici* respectfully request this Court to make it clear that any decision in favor of petitioner with respect to the payment of contingent fees is not intended to apply to statutory fee cases.

CONCLUSION

For all of the foregoing reasons, *amici* urge this Court to affirm the decisions of the United States Courts of Appeals for the Sixth and Ninth Circuits.

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In The Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

JOHN W. BANKS, II,

Respondent.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

SIGITAS J. BANAITIS,

Respondent.

On Writs Of Certiorari To The United States Courts Of Appeals For The Sixth And Ninth Circuits

AMICI CURIAE BRIEF OF MOUNTAIN STATES LEGAL FOUNDATION, SOUTHEASTERN LEGAL FOUNDATION, DEFENDERS OF PROPERTY RIGHTS, AMERICAN CENTER FOR LAW AND JUSTICE, LIBERTY LEGAL INSTITUTE, OREGONIANS IN ACTION LEGAL CENTER, ALLIANCE DEFENSE FUND, NATIONAL LEGAL FOUNDATION, ATLANTIC LEGAL FOUNDATION, TEXAS JUSTICE FOUNDATION, NEW ENGLAND LEGAL FOUNDATION, AND LANDMARK LEGAL FOUNDATION IN SUPPORT OF RESPONDENTS

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QUESTION PRESENTED

Whether, under Section 61(a) of the Internal Revenue Code, 26 U.S.C. § 61(a), a taxpayer's gross income from the proceeds of litigation includes the portion of his damages recovery that is paid to his attorneys pursuant to a contingent fee agreement.

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AMICI CURIAE BRIEF OF MOUNTAIN STATES LEGAL FOUNDATION, SOUTHEASTERN LEGAL FOUNDATION, DEFENDERS OF PROPERTY RIGHTS, AMERICAN CENTER FOR LAW AND JUSTICE, LIBERTY LEGAL INSTITUTE, OREGONIANS IN ACTION LEGAL CENTER, ALLIANCE DEFENSE FUND, NATIONAL LEGAL FOUNDATION, ATLANTIC LEGAL FOUNDATION, TEXAS JUSTICE FOUNDATION, NEW ENGLAND LEGAL FOUNDATION, AND LANDMARK LEGAL FOUNDATION

Mountain States Legal Foundation respectfully submits this *amici curiae* brief on behalf of itself, Southeastern Legal Foundation, Defenders of Property Rights, American Center for Law and Justice, Liberty Legal Institute, Oregonians in Action Legal Center, Alliance Defense Fund, National Legal Foundation, Atlantic Legal Foundation, Texas Justice Foundation, New England Legal Foundation, and Landmark Legal Foundation in support of Respondents. Pursuant to Supreme Court, Rule 37(3)(a), this brief is filed with the written consent of all the parties.[1]

INTEREST OF THE *AMICI CURIAE*

Whether attorneys' fees recovered by Public Interest Law Firms (PILFs) are taxable to their clients is of vital concern to Mountain States Legal Foundation and the other *amici*. If this Court rules in favor of the Commissioner with

[1] Copies of the consent letters have been filed with the Clerk of the Court with this brief. In compliance with Supreme Court Rule 37(6), *amici curiae* represent that no counsel for any party authored this brief in whole or in part, and that no person or entity, other than *amici curiae*, their members, or their counsel, made a monetary contribution for the preparation or submission of this brief.

sufficiently expansive language, there is reason to believe that the Commissioner will argue that attorneys' fees paid to PILFs are taxable to their clients. This would adversely impact the ability of PILFs to undertake their vital role in the judicial system: providing free legal services in matters of broad public interest to clients who could not otherwise afford legal representation. While *amici* represented here may have different views with respect to substantive issues of great public interest, they all agree that taxation of their clients for the attorneys' fees PILFs recover pursuant to federal fee-shifting statutes would be a blow to their mission of representing the public interest as Congress intended.

Therefore, *amici* support the taxpayers in this case and the decisions of the Sixth and Ninth Circuit Courts of Appeals and urge this Court to affirm those decisions. However, because Mountain States Legal Foundation and the other *amici*, as PILFs, are unique in their legal status, their "representation" agreements, and their relationship with their clients, they wish to demonstrate to this Court that their clients may not be taxed for the attorneys' fees received by PILFs that represent them and to inform this Court of the devastating impact that an expansive ruling for the Commissioner could have upon PILFs' ability to carry out their mission.

Mountain States Legal Foundation, like each of the other *amici* that have joined this brief, is organized and operated exclusively for charitable purposes, with no part of its net earnings inuring to the benefit of any private shareholder, member, or individual. As such, the *amici* are exempt from taxation as PILFs under § 501(c)(3) of the Internal Revenue Code (26 U.S.C. § 501(c)(3)). Necessarily, all the *amici* serve public rather than private interests in

their litigation. 26 C.F.R. § 1.501(3)(c)-1(d)(ii). Therefore, while PILFs litigate on behalf of private litigants, they do so only when the litigation can reasonably be said to serve a broad public interest, rather than a private interest, as provided by Rev. Proc. 92-59, which governs 501(c)(3) qualified PILFs. Pursuant to Rev. Proc. 92-59, none of the *amici* charge their clients legal fees, but rather provide legal services without charge to their clients.

In many cases, PILFs seek only declaratory and injunctive relief; in many other cases, damage awards are minimal. Because some of these cases take years to litigate to conclusion, PILFs' attorneys' fees incurred on behalf of their clients can be very substantial. PILFs earn those fees by serving an important role in the judicial system: protecting the public interest and providing legal representation to those citizens who cannot afford to hire a private attorney to defend or prosecute their interests in matters of public importance. Ginsburg, *In Pursuit of the Public Good: Access to Justice in the United States*, 7 Wash. U. J.L. & Pol'y 1, 8 (2001); *see also*, Daly, *In-Person Solicitation by Public Interest Law Firms; A Look at the ABA Code Provisions in Light of Primus and Ohralik*, 49 Geo. Wash. L. Rev. 309, 337 (1981) (arguing that PILFs "bring the American legal systems one step closer to attaining the goal of equal justice for all").

Even though PILFs' clients do not pay attorneys' fees, in light of the important role PILFs serve Congress intended for PILFs to take advantage of various federal fee-shifting statutes. *See*, *Blum v. Stenson*, 465 U.S. 886, 892-896 (1984) (non-profit, legal aid society entitled to attorneys' fees under 42 U.S.C. § 1988); *New York Gaslight Club, Inc. v. Carey*, 447 U.S. 54, 70, n. 9 (1980) (PILF entitled to attorneys' fees under Title VII of the Civil

Rights Act of 1964); *Cornella v. Schweiker*, 728 F.2d 978, 985-87 (8th Cir. 1984) (*pro bono* legal service organization entitled to attorneys' fees under the Equal Access to Justice Act); *Ed. A. Wilson, Inc. v. General Services Administration*, 126 F.3d 1406, 1409 (Fed. Cir. 1997) (under EAJA, an award of attorneys' fees is not contingent upon an obligation to pay counsel because the presence of an attorney-client relationship suffices to entitle prevailing litigants to receive fee awards if there is an express or implied agreement that the fee award will be paid to the legal representative); *Preseault v. United States*, 52 Fed. Cl. 667, 673-677 (Fed. Cl. 2002) (PILF entitled to attorneys' fees under the Uniform Relocation Assistance and Real Property Acquisition Policies Act) (*amici* New England Legal Foundation represented Preseault).

Likewise, the Commissioner, recognizing the important role PILFs play in the judicial process, has determined that PILFs are able to collect attorneys' fees incurred on clients' behalf pursuant to federal fee-shifting statutes without jeopardizing their 501(c)(3) status. For example, Rev. Proc. 92-59 allows PILFs to collect attorneys' fees if those fees are awarded by a court or administrative agency, or approved by such a body in a settlement agreement, but only if: (1) the likelihood or probability of a fee is not a consideration in the selection of the case; (2) a case in which a court awarded fee is possible is not accepted if the litigants have a sufficient commercial or financial interest in the outcome of the litigation to justify representation by a private law firm; and (3) the total amount of all attorneys' fees recovered by the PILF does not exceed 50 percent of the PILF's budget for legal functions, calculated over a five-year period.

Congress' intent that PILFs receive attorneys' fees under federal fee-shifting statutes would be frustrated,

however, if clients of PILFs had to include those attorneys' fees in their gross income. Take, for example, a plaintiff who sues for a violation of her civil rights. Such a plaintiff generally cannot afford to pay an attorney on an hourly basis; moreover, any potential damage award may not be large enough to entice a private attorney to enter into a "contingent fee" agreement. *See*, S.Rep. No. 94-1011, *reprinted in*, 1976 U.S.C.C.A.N. 5908, 5910 (recognizing that civil rights plaintiffs generally obtain injunctive relief that is sometimes accompanied by a modest damage award). Thus, the plaintiff may be able to vindicate her civil rights only if a PILF represents her free of charge. *See, e.g.*, *Missouri v. Jenkins*, 491 U.S. 274 (1989) (students represented by NAACP in school desegregation case). If these attorneys' fees were included in the plaintiff's gross income, she would be faced with a huge tax liability that she could not pay, which would create an insurmountable disincentive for her to vindicate her civil rights or to resist unlawful or unconscionable conduct by the federal or state governments. *See, e.g.*, Sager and Cohen, *How the Income Tax Undermines Civil Rights Law*, 73 S. Cal. L. Rev. 1075 (2000).

Thus, the *amici* herein deem it critical that their views of the issue before the Court be heard and that this Court's decision not be so expansive as to allow the Commissioner to argue that attorneys' fees recovered by PILFs are taxable to their clients.[2]

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[2] Without willing clients, PILFs could not fulfill their charitable purposes. Granted, PILFs could waive any attorneys' fees to which they may be entitled under fee-shifting statutes and, thus, avoid any potential tax liability to their clients. However, by allowing PILFs to receive attorneys' fees under fee-shifting statutes, Congress concluded that the receipt of these fees will ensure the continued existence and viability of PILFs, in order to fulfill the purposes intended by Congress.

STATEMENT OF THE CASE

Amici agree with the Statement of the Case set forth in the briefs of the Respondents.

SUMMARY OF THE ARGUMENT

The opinions of the Sixth and Ninth Circuits should be affirmed. However, should the Court reverse those decisions and rule in favor of the Commissioner, this Court should make clear that its ruling has no application to PILFs. PILFs' "representation" agreements are not "contingent fee" agreements, as set out in the Question Presented, because they do not involve the assignment of any client income or the discharge of any client indebtedness. Therefore, attorneys' fees recovered by PILFs under federal fee-shifting statutes are not includable in the gross income of PILFs' clients.

ARGUMENT

I. THE OPINIONS OF THE SIXTH AND NINTH CIRCUITS SHOULD BE AFFIRMED.

Amici agree with Respondents, in the particularized context of the facts and Question Presented: "Whether the gross income from the proceeds of litigation includes the portion of his damages recovery that is paid to his attorneys pursuant to a contingent fee agreement." In this context, *amici* support Respondents on the following points:

1. The attorneys' fees paid to the attorneys in these cases were earned by the attorneys and not the clients.
2. The position of the Commissioner in these cases results in double taxation.
3. The contingent fee agreements in these cases were in the nature of partnerships, joint ventures, or co-ownership of the claims and no assignment of income resulted from these agreements.
4. The attorneys' fees paid to the attorneys in these cases are not taxable to their clients.

In addition to the arguments set forth by Respondents, *amici* submit that this Court should uphold the opinions below because *amici* may be impacted adversely by a decision in favor of the Commissioner if the language of any such decision is sufficiently expansive to permit the Commissioner to apply it to tax PILFs' clients for attorneys' fees recovered by PILFs under federal fee-shifting statutes. Because this issue is critically different factually and legally from that presented to the Court in the cases before it, the *amici* have unique information and perspective that can assist the Court concerning the possible application the Commissioner may make of this case to tax PILFs' clients for the attorneys' fees recovered by PILFs under federal fee-shifting statutes.

II. PILFs' "REPRESENTATION" AGREEMENTS ARE NOT "CONTINGENT FEE" AGREEMENTS.

Should this Court determine that the fees paid to the attorneys in these cases are taxable income of their clients, this Court should provide that its holding does not

apply to "representation" agreements entered into by PILFs and their clients because those agreements are not "contingent fee" agreements that anticipatorily assign income or discharge debt.

There are only two theories on which the taxability to a client of attorneys' fees paid to the client's attorney, pursuant to a "contingent fee" agreement, may be predicated:

1. The "contingent fee" agreement constitutes an anticipatory assignment of taxable income earned by the client under *Lucas v. Earl*, 281 U.S. 111 (1930), and *Helvering v. Horst*, 311 U.S. 112 (1940). This requires a finding that some or all of the damage award represents the recovery of income earned by the client, under 26 U.S.C. § 61, and the attorney is to be paid from that damage award in an amount determined with reference to the amount of that award; or

2. The "contingent fee" agreement obligates the client to pay attorneys' fees determined by the amount of a damage award and those fees are paid by the opposing party, which constitutes a discharge of the client's indebtedness to the attorney, under 26 U.S.C. § 61(a)(12).

Neither of these theories applies to the unique "representation" agreements entered into by PILFs and their clients. PILFs' agreements are neither "contingent" agreements nor "fee" agreements as those terms are used in the Question Presented. Moreover, PILFs' "representation" agreements result in neither an anticipatory assignment of income by, nor a discharge of indebtedness of, the PILFs' clients.

A. REPRESENTATION AGREEMENTS BETWEEN PILFs AND THEIR CLIENTS DO NOT CONSTITUTE AN ANTICIPATORY ASSIGNMENT OF INCOME BY THEIR CLIENTS TO PILFs.

1) PILFs' attorneys' fees cannot constitute an assignment of income because the fees are recovered from third parties, not from any taxable damage award to their clients.

Unlike the Sixth and Ninth Circuits, several other circuits have held that attorneys' fees paid by a defendant to a plaintiff's attorneys pursuant to a "contingent fee" agreement must be included in the plaintiff's gross income based upon the anticipatory assignment of income doctrine. *E.g.*, *Kenseth v. Commn'r*, 259 F.3d 881 (7th Cir. 2001); *Young v. Commn'r*, 240 F.3d 369, 376-79 (4th Cir. 2001); *Hukkanen-Campbell v. Commn'r*, 274 F.3d 1312, 1313-15 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002); *Baylin v. United States*, 43 F.3d 1451, 1454 (Fed. Cir. 1995). The agreements that those cases address are totally different from the "representation" agreements between PILFs and their clients. Those cases involved "contingent fee" agreements that entitled the attorneys to recover fees from their clients' damage awards based on the amount of those awards.

For example, in *Kenseth*, the plaintiff entered into a "contingent fee" agreement with a law firm to represent him in an age-discrimination suit against his former employer seeking, *inter alia*, a recovery of taxable past wages. 259 F.3d at 882. Pursuant to that agreement, the law firm received 40 percent of the proceeds of the settlement entered into between the plaintiff and his former

employer. *Id.* The Seventh Circuit determined that the "contingent fee" agreement had effectuated an anticipatory assignment of gross income earned by the client to the client's lawyer, contrary to *Earl* and *Horst*, *supra* at 8.

However, PILFs' "representation" agreements, consistent with PILFs' charitable purposes, do not allow PILFs to recover anything at all from damage awards or to determine the amount of attorneys' fees PILFs may recover under federal fee-shifting statutes by reference to the amount of such damage awards. Rather, PILFs, under agreement and applicable law, may recover only what the Court determines is a fair and reasonable amount, based on time spent, the complexity of the issues, and other factors, all in accordance with federal fee-shifting statutes. Because PILFs' agreements and applicable law do not permit PILFs: to recover attorneys' fees from any damages awarded to the clients; to base their attorneys' fees on the amounts of those damages; or indeed, even to consider attorneys' fees in deciding whether to take the case; the "representation" agreements of PILFs do not involve the anticipatory assignment of a client's gross income.

2) Attorneys' fees recovered by PILFs under federal fee-shifting statutes are earned by the PILF, not by the client, and therefore do not involve an assignment of the client's income.

Two cases, *Earl*, 281 U.S. at 114-15 (1930), and *Horst*, 311 U.S. at 114 (1940), formulated the "anticipatory assignment of income doctrine" and established the "first principle of income taxation: income must be taxed to him who earns it." *Commn'r v. Culbertson*, 337 U.S. 733, 739-740 (1949).

The anticipatory assignment of income doctrine cannot and does not apply to PILFs because PILFs, and not their clients, "earn" the attorneys' fees that might be awarded. Indeed, it is well established that *pro se* litigants are not entitled to attorneys' fees under federal fee-shifting statutes. *E.g.*, *Corrigan v. United States*, 27 F.3d 436 (9th Cir. 1994) (*pro se* litigants are not entitled to attorneys' fees under IRC § 7430); *Krecioch v. United States*, 316 F.3d 684, 688 (7th Cir. 2003) (*pro se* litigants are not entitled to attorneys' fees under the Equal Access to Justice Act ("EAJA"), 28 U.S.C. § 2412); *Smith v. DeBartoli*, 769 F.2d 451, 453 (7th Cir. 1985) (*pro se* litigants are not entitled to attorneys' fees under the Civil Rights Attorney's Fees Award Act of 1976, 42 U.S.C. § 1988); *Naekel v. Dep't of Transportation*, 845 F.2d 976, 979-980 (Fed. Cir. 1988) (*pro se* litigants are not entitled to attorneys' fees under Back Pay Act, 5 U.S.C. § 5596(b)(1)(A)). Thus, if the PILFs' clients had represented themselves *pro se*, they would not have been entitled to an award of attorneys' fees. Hence, any attorneys' fees that may be recovered by PILFs are "earned" solely by the PILF that represents the client, not by the client. Therefore, the attorneys' fees, if taxable, must be taxed only to the PILF as the "tree" from which the "fruits" (*i.e.*, attorneys' fees) "grew." *Earl*, 281 U.S. at 115. A contrary conclusion would violate the "first principle of income taxation: that income must be taxed to him who earns it." *Culbertson*, 337 U.S. at 739-740.

The Commissioner might argue that the clients "earned" the attorneys' fees recovered by PILFs because, under most fee-shifting statutes, the client, as the prevailing party, is the one who is deemed to have incurred the attorneys' fees and, hence, the one who is entitled to an award of those fees. *See, e.g.*, Uniform Relocation Assistance

and Real Property Acquisition Policies Act (URA) 42 U.S.C. § 4654(c) ("the court . . . shall determine and award . . . plaintiff . . . reasonable attorneys fees"); 42 U.S.C. § 1988 (a court may award reasonable attorneys' fees to a "prevailing party"); *see also*, *Evans v. Jeff D.*, 475 U.S. 717, 731-732 (1986) (42 U.S.C. § 1988 does not bestow fee awards upon attorneys). The Commissioner's argument would be in error.

Although PILFs receive attorneys' fees for their representation of their clients, the clients are not obligated to pay any attorneys' fees because, in accordance with PILFs' charitable nature and Rev. Proc. 92-59, PILFs provide their legal services to clients free of charge.[3] The clients do agree, however, that, if awards of attorneys' fees were available under federal fee-shifting statutes, PILFs may seek those awards in the clients' names, as required by law. The clients further agree that any attorneys' fees recovered are the property of the PILFs.

The relationship between PILFs and their clients is analogous to the facts addressed by the Commissioner in Rev. Rul. 65-282, which involved a state law that provided that attorneys representing indigent clients were eligible for court-awarded attorneys' fees. *Id.* The question presented was whether an attorney who receives these court-awarded fees must include them in his gross income even though he is obligated contractually to turn the fees over to his employer, a legal aid society. *Id.* The Commissioner held that such fees were excluded from the attorney's

[3] The value of these services is not to be included in a client's gross income because the services were provided gratuitously by a charitable organization. *Cf.* 26 U.S.C. § 102 (excluding gifts from the definition of gross income).

gross income because the attorney received those fees as an "agent[] for the legal aid society." *Id.*; *see also*, Rev. Rul. 69-274.

Likewise, PILFs' clients act only as the PILFs' agents in applying for and, possibly, in being determined to have "incurred" attorneys' fees. Because the federal fee-shifting statutes provide that only the client is eligible for attorneys' fees, the attorney's fee application must be submitted in the name of the client. *Cf. Phillips v. General Services Admin.*, 924 F.3d 1577, 1582 (Fed. Cir. 1991) (request for attorneys' fees under EAJA must be made on behalf of the "prevailing party").

Rev. Rul. 80-364, which involved a suit filed by a union on behalf of its members against a company for violating a collective bargaining agreement, further supports this conclusion. After filing suit, the union and the company entered into a settlement agreement under which the company paid the union $40,000.00 in full settlement of all claims. *Id.* The union kept $6,000.00 of the settlement as attorneys' fees and returned $34,000.00 to the employees for back pay owed to them. *Id.* The back pay was distributed among the employees in proportion to their claims. *Id.*

The Commissioner concluded that the amount of the settlement that went toward attorneys' fees was not remuneration to the individual employees because the attorneys' fees reimbursed the union for expenses incurred to enforce the collective bargaining agreement. *Id.* Thus, although the union members had to pay taxes on the back pay they received, the attorneys' fees were excluded from their gross income. *Id.* In reaching this conclusion, the Commissioner evidently applied the "first principle of

income taxation: that income must be taxed to him who earns it." *Culbertson*, *supra*, 337 U.S. at 739-40.

There is no appreciable distinction between the facts in Rev. Rul. 80-364 and the facts involving the "representation" agreements of PILFs. Indeed, as to both cases: (1) the attorneys provide legal services to their clients free of charge;[4] (2) there is a payment to the client that constitutes either back pay or "just compensation"; (3) there is an agreement or statute that allows for court-awarded attorneys' fees; and (4) the clients have no legal claim to any attorneys' fees. If the attorneys' fees were not included in the client's gross income in Rev. Rul. 80-364, *a fortiori*, they may not be included in PILFs' clients' gross income.

B. THE RECOVERY OF ATTORNEYS' FEES BY PILFs PURSUANT TO FEDERAL FEE-SHIFTING STATUTES DOES NOT CONSTITUTE THE DISCHARGE OF AN INDEBTEDNESS.

The Commissioner considers attorneys' fees paid by a defendant to a plaintiff's attorney, pursuant to a "contingent fee" agreement, to be a discharge of a debt and, therefore, includable in the plaintiff's gross income. (Comm'rs' Brief at 19) *See*, 26 U.S.C. § 61(a)(12) (defining "gross income" to include "[i]ncome from discharge of indebtedness"). The Commissioner relies on *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929) (Comm'rs' Brief at 19), which does not involve attorneys' fees, and

[4] Although the union may have been the "named" plaintiff in Rev. Rul. 80-364, the "real" clients were the union members. *See, Hunt v. Washington Apple Adver. Comm'n*, 432 U.S. 333, 341-344 (1977) (establishing that an association may sue on behalf of its members).

could have cited, as well, *Sinyard v. Commn'r*, 286 F.3d 756, 757 (9th Cir. 2001), *cert. denied*, 536 U.S. 904 (2002), which does involve attorneys' fees. In *Sinyard*, the plaintiff entered into a "contingent fee" agreement with a law firm to represent him in two class action lawsuits against his former employer. Pursuant to that agreement, the law firm was to receive "one-third" of any recovery. *Id.* The lawsuits were settled with the former employer paying directly to the law firm the amount of attorneys' fees that the former employee owed. *Id.* at 757-758. In a split decision, a panel of the Ninth Circuit ruled that the attorneys' fees were includable in the client's gross income because the former employer, in paying the attorneys' fees directly to the attorney, was paying a debt that the client owed to his attorney. *Id.* at 758. This rule does not apply to PILFs.

PILFs are non-profit organizations that may not consider the possibility of the attorneys' fees available under federal fee-shifting statutes when they undertake to represent their clients, may not undertake cases in which an award of attorneys' fees is possible if the client can reasonably retain private counsel, and must represent their clients free of charge. Therefore, recovery of attorneys' fees by PILFs under federal fee-shifting statutes does not constitute the discharge of the clients' indebtedness. By agreement and by law, clients do not owe PILFs one penny for attorneys' fees, nor may those fees be charged to or recovered from PILFs' clients. There being no ability to assess and no obligation to pay attorneys' fees, there can be no indebtedness to be discharged. Indeed, the obligation to pay attorneys' fees belongs to the party ordered to do so under federal fee-shifting statutes. *See, e.g.*, 42 U.S.C. § 4654(c) (the court "*shall* determine and award" reasonable

attorneys' fees) (emph. supp.). Therefore, in paying attorneys' fees, the federal or state government agency or subdivision could not be discharging a debt owed by or a contractual obligation of the PILF's client. Instead, it would be satisfying only its own statutory obligation.

Moreover, "representation" agreements of PILFs are not "contingent fee" agreements as that phrase is used in the Question Presented. Such agreements are only "contingent if the obligation to pay depends on a particular result being obtained." *City of Burlington v. Dague*, 505 U.S. 557, 561 (1992). Generally, if the client does not win, no debt arises and the attorney does not get paid. *Id.* Thus, "contingent fee" agreements allow clients who are unable to finance their own litigation to pursue their claims by assigning a portion of any future damage award to an attorney in exchange for the attorney's assumption of the financial risk associated with an unsuccessful outcome. *Gisbrecht v. Barnhart*, 535 U.S. 789, 810 (2002) (Scalia, J., dissenting). Attorneys are willing to assume the risk associated with such agreements because, *inter alia*, those agreements allow them to expand their potential client base to include clients who cannot afford to pay an hourly fee.

Thus, the distinctive characteristics of a "contingent fee" agreement include: (1) a debt will be incurred by the plaintiff to his attorney if he prevails by recovering a damage award: (2) that debt will be discharged by either the plaintiff or a third party; and (3) the attorney possesses a pecuniary interest that is determined by reference to the amount of and payable from the damages awarded to the client. By contrast, the "representation" agreements of PILFs contain none of these elements because attorneys' fees are neither paid from nor determined by the amount

of the damages awarded and there is no debt incurred by the client to the PILF.

III. PUBLIC POLICY DICTATES THAT ANY ATTORNEYS' FEES RECOVERED BY PILFs PURSUANT TO FEDERAL FEE-SHIFTING STATUTES NOT BE INCLUDED IN THE GROSS INCOME OF THEIR CLIENTS.

A decision sufficiently expansive to allow the Commissioner to argue that attorneys' fees recovered by PILFs are taxable to their clients is not in the public interest. Congress has recognized expressly that a successful civil rights plaintiff acts, not only for herself, but also as a "private attorney general" by "vindicating a policy that Congress considered of the highest priority." *See*, S.Rep. No. 94-1011, *reprinted in*, 1976 U.S.C.C.A.N. 5908, 5910. A putative civil rights plaintiff, however, will not file suit if she may incur a tax liability when her PILF receives court-awarded attorneys' fees under a fee-shifting statute. Thus, if the Commissioner is successful here, the entire nation, not just the individual citizen, will suffer because "those who violate the Nation's fundamentals laws" will do so with "impunity." *Id.*

Not only would enforcement of federal civil rights laws suffer, but enforcement of federal environmental laws will also suffer. Since 1970, Congress has allowed private citizens to enforce federal environmental laws by including "citizen suit" provisions in them. *See, e.g.*, the Clean Air Act, 42 U.S.C. § 7604(d); the Clean Water Act, 33 U.S.C. § 1365; the Resource Conservation and Recovery Act, 42 U.S.C. § 6972(e); the Comprehensive Environmental Response, Compensation and Liability Act, 42 U.S.C. § 9659(f); and the Endangered Species Act, 16 U.S.C.

§ 1540(g). These "citizen suit" provisions generally authorize two types of actions: (1) enforcement actions against violators; and (2) actions to compel the appropriate federal agency to perform nondiscretionary duties required by the statute. Dunne, *Attorney's Fees For Citizen Enforcement of Environmental Statutes: The Obstacles for Public Interest Law Firms*, 9 Stan Envtl. L.J. 1, 2-3 (1990). Because these "citizen suits" do not result in an award of damages, Congress included an attorneys' fees provision that allows courts to award attorneys' fees to the "successful citizen-enforcers." *Id.* Congress included these attorneys' fees provisions to ensure that the "citizen-enforcers" had competent representation. *Id.* at 5. Moreover, Congress sought to entice PILFs to represent "citizen-enforcers" by allowing the PILFs to recover their attorneys' fees under these fee-shifting provisions. *Id.* at 8.

Congress' intent, however, would be defeated if "citizen-enforcers" had to include the attorneys' fees that were awarded to their PILFs in their gross income. Indeed, under such a scenario, putative "citizen-enforcers" of modest means would not file suit because they could not afford the concomitant tax liability. This would leave the enforcement of federal environmental statutes to either the wealthy or the federal government, neither of which is a "suitable champion" to ensure compliance with federal environmental laws.[5]

The effects of a ruling sufficiently expansive to allow the Commissioner to argue that the recovery of attorneys'

[5] Indeed, if the federal government were capable of ensuring compliance with all of the federal environmental statutes, Congress would have had no reason to include "citizen suit" provisions in those statutes.

fees by PILFs is taxable to their clients will also be felt outside the PILF arena. Take, for example, a union that represents a member, on a *pro bono* basis, in a wrongful discharge suit. If the union prevails, it may be entitled to court-awarded attorneys' fees under either a federal fee-shifting provision or a collective bargaining agreement. *See*, *Raney v. Federal Bureau of Prisons*, 222 F.3d 927 (Fed. Cir. 2000) (federal employee union entitled to attorneys' fees under the Back Pay Act). There has been no suggestion that the union member must include the attorneys' fees received by the union in his gross income. *See*, Rev. Rul. 80-364 (payment of union's attorneys' fees not includable in a union member's "gross income"). Yet, an expansive ruling in the instant cases might yield that result.

Finally, clients of the private bar will also feel the effects of an adverse ruling. Most states recommend that private attorneys provide a certain amount of *pro bono* legal services each year. *E.g.*, Colorado Rules of Professional Conduct 6.1 (recommending 50 hours per year). Many attorneys fulfill this goal by representing indigent clients. Although these attorneys do not charge their clients a fee, often a court will award fees to the attorney under a fee-shifting statute. A sufficiently expansive adverse ruling in the instant cases, however, could result in the inclusion of such attorneys' fees in the gross income of an indigent client. Such a result would mean that taxes would be paid on the attorneys' fees twice, once by the private attorney and once by the indigent client. More seriously, such a result would deny legal representation to indigent clients. *Porter v. U.S. Agency for Int'l Dev.*, 293 F.Supp.2d 152, 155-57 (D.D.C. 2003).

CONCLUSION

The opinions of the Sixth and Ninth Circuits should be affirmed. However, should the Court reverse those decisions and rule in favor of the Commissioner, this Court should make clear that its ruling has no application to PILFs because those agreements do not assign any income of their clients and because recovery by PILFs of attorneys' fees under federal fee-shifting statutes is not a discharge of any client indebtedness. Hence, the "representation" agreements of PILFs are not "contingent fee" agreements, as used in the Question Presented, and attorney fees recovered by PILFs under federal fee-shifting statutes are not includable in the gross income of PILFs' clients.

Respectfully submitted,

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COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

JOHN W. BANKS, II
Respondent.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SIGITAS J. BANAITAS
Respondent.

On Writs of Certiorari to the United States Courts of Appeals for the Sixth and Ninth Circuits

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BRIEF OF NATIONAL EMPLOYMENT LAWYERS ASSOCIATION, NAACP LEGAL DEFENSE AND EDUCATION FUND, INC., AARP, TRIAL LAWYERS FOR PUBLIC JUSTICE, PUBLIC ADVOCATES, INC. AND THE WESTERN CENTER ON LAW AND POVERTY AS *AMICI CURIAE* IN SUPPORT OF RESPONDENTS

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INTEREST OF *AMICI CURIAE*[1]

All *amici* here, either organizationally or through their members, represent individuals under Federal fee shifting statutes, including Title VII of the Civil Rights Act of 1964, the Equal Pay Act, 42 U.S.C. §§ 1981 and 1983, the Age Discrimination in Employment Act, the Rehabilitation Act of 1973, the Americans with Disabilities Act and the Family and Medical Leave Act. The payment of attorneys' fees in such litigation is contingent in the sense that the defendant only pays fees if the plaintiff prevails, but the fee award is separate from judgment on the merits. This is unlike the situation in "ordinary" contingent fee cases, where fees are apportioned from the merits judgment, with lawyer and client each taking a share.

In fee shifting cases under civil rights statutes, the relief sought may be exclusively, or predominantly, injunctive. Indeed, the only money awarded in some cases may be the attorneys' fees themselves. If the plaintiffs in these or similar cases are required to pay taxes on fees that go to their lawyers, they will lose money by winning a lawsuit. Even the most meritorious civil rights claims will not be pursued, and the fundamental goal of fee shifting—encouraging citizens to act "as a 'private attorney general,' vindicating a policy that Congress considered of the highest priority," *Newman v. Piggie Park Enterprises, Inc.*, 390 U.S. 400, 402 (1968)—will be nullified. All *amici* share an interest in seeing that this does not occur.

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[1] The parties have consented to the filing of this brief, and their letters of consent are on file with the Clerk. Counsel for *amici curiae* certify that this brief was not written, in whole or part, by counsel for a party, and that no person or entity, other than *amici curiae* and counsel, made a monetary contribution to the preparation or submission of the brief. Supreme Court Rule 37.6.

Amici also have an interest in the plaintiff's tax liability for fees received by lawyers under ordinary contingent fee agreements, because such agreements may provide the only vehicle for financing litigation on behalf of impecunious individuals, especially if fee shifting statutes are not available. Fuller statements of interest for all *amici* are included in the appendix to this brief.

STATEMENT

These consolidated cases both involve the tax treatment of fees paid to plaintiff's counsel in employment litigation undertaken under a contingent fee agreement. Contrary to the Solicitor General's assumption, however, there are significant differences between the two cases, requiring different modes of analysis.[2]

In No. 03-892, respondent Banks originally sued his employer under both Federal and state law. But by the time the case settled for $464,000 ($150,000 of which went to counsel), only the three Federal claims remained viable, arising under Title VII and 42 U.S.C. §§ 1981, 1983. *Banks v. Commissioner*, 345 F.3d 373, 379 (6th Cir. 2003). All three of these claims were subject to statutory fee shifting. *See* 42 U.S.C. § 2000e-5(k) (Title VII), and 42 U.S.C. § 1988 (§§ 1981, 1983).

In No. 03-907, in contrast, respondent Banaitis pursued two common law Oregon tort claims. *Banaitis v. Commissioner*, 340 F.3d 1074, 1077 (9th Cir. 2003). Such claims were not subject to fee shifting. The case ultimately settled for $8,728,559, of which $3,864,012 was paid to counsel. *Id.* at 1078.

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[2] As the Solicitor General notes, Brief for Petitioner at 15 n.3, neither case involves recoveries for "personal physical injuries or physical sickness," which are excluded from gross income under 26 U.S.C. § 104(a)(2).

Both the Sixth Circuit in *Banks* and the Ninth in *Banaitis* held that the fees received by counsel should not be treated as income to the plaintiff. Consequently, those fees were subject to taxation only as income to the lawyers. The two courts employed different rationales. The Ninth Circuit viewed state lien law as dispositive, as in *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), and stressed that Oregon law was comparable to that in Alabama (as analyzed in *Cotnam*) in granting superior rights to lawyers. 340 F.3d at 1082-83. The Sixth Circuit rejected a "state-by-state" approach, instead likening Banks' lawyer to a "tenant in common of the orchard owner [who] must cultivate and care for and harvest the fruit of the entire tract." 345 F.3d at 384-85. The Sixth Circuit did not focus on the fee shifting statutes under which Banks' claims arose.

SUMMARY OF ARGUMENT

In both these cases, the taxpayer derived income from settlement of a lawsuit against his employer, and in both cases the underlying litigation featured a contingent fee agreement between the taxpayer and counsel. In *Banks*, however—unlike *Banaitis*—the settled claims arose under Federal fee shifting statutes. This distinction is crucial.

1. Whatever the proper result in ordinary contingent fee litigation, fees awarded by a court under a fee shifting statute (or paid as part of a settlement) are not income to the plaintiff. The "assignment of income" doctrine, developed in cases like *Lucas v. Earl*, 281 U.S. 111 (1930), and *Helvering v. Horst*, 311 U.S. 112 (1940), simply has no application to the statutory fee model, because statutory fees are not intended to liquidate a private debt owed by a plaintiff to counsel.

This Court has explained that a private plaintiff in a civil rights case acts "as a 'private attorney general,' vindicating a policy that Congress considered of the highest priority." *Newman v. Piggie Park Enterprises, Inc.*, 390 U.S. at 402.

Resources are required for successful prosecutions by any attorney general, public or private, and Congress "enacted the provision for counsel fees . . . to encourage individuals injured by racial discrimination to seek judicial relief." *Id.* The "aim" of fee shifting is to encourage meritorious litigation by "enabl[ing] civil rights plaintiffs to employ reasonably competent lawyers without cost to themselves if they prevail." *Venegas v. Mitchell*, 495 U.S. 82, 86 (1990).

A statutory fee case, unlike ordinary contingent fee litigation, entails two distinct awards, separated temporally: (1) judgment on the merits, which may be declaratory or injunctive relief or damages from a jury, followed by (2) attorneys' fees awarded by the court. Judicial awards at "stage 2" are divorced from any private agreements between plaintiff and counsel, *Blanchard v. Bergeron*, 489 U.S. 87, 93 (1989), and are intended to produce "fees which are adequate to attract competent counsel, but which do not produce windfalls to attorneys." *Blum v. Stenson*, 465 U.S. 886, 893-94 (1984).

The difference between statutory fees and ordinary contingent fees is perhaps best illustrated by the eligibility of *pro bono* legal organizations for statutory fees at normal market rates, even though the plaintiff owes them nothing. *Id.* at 894. This makes it clear that statutory fees are not intended to discharge private obligations.

Statutory fees and ordinary contingent fees also differ in another crucial respect. Unlike ordinary contingent fees, which are some percentage of the merits recovery, it is not unusual for a statutory fee award to be larger than the merits judgment. *City of Riverside v. Rivera*, 477 U.S. 561 (1986). In such cases, if attorneys' fees are considered income to the plaintiff, the operation of the Alternative Minimum Tax will frequently result in a prevailing plaintiff's suffering a net financial loss. *See, e.g., Porter v. Director, Agency for International Development*, 293 F.Supp.2d 152 (D.D.C.

2003) (plaintiff who won a jury verdict of $30,000 plus a fee award could suffer a post-tax loss of nearly $50,000). The plaintiff in the worst posture is the one who seeks, and secures, purely injunctive relief; she receives no money herself but pays taxes on every dollar that her lawyer is awarded in fees.

A key objective of fee shifting, however, is to permit plaintiffs "to employ . . . lawyers *without cost* to themselves if they prevail." *Venegas v. Mitchell*, 495 U.S. at 86 (emphasis added). Including statutory fees in the plaintiff's income undermines this congressional goal and is not required by unyielding tax principles. The evils addressed by *Lucas v. Earl* and *Helvering v. Horst* are simply not present in the fee shifting context. In particular, this is not a situation in which a plaintiff is assigning his own income to counsel. On the contrary, the plaintiff himself has no statutory right to the fee award, even if he is a lawyer, since judicially ordered fees are intended only for retained counsel. *Kay v. Ehrler*, 499 U.S. 432 (1991). Nor is it a case of the defendant paying a private debt owed by plaintiff to counsel, since statutory fees are independent of private fee agreements. *Blum v. Stenson, supra; Blanchard v. Bergeron, supra.* Finally, this is not a situation in which an amount will go untaxed unless deemed income to the plaintiff. An award of attorneys' fees is without question income to counsel, and counsel pays taxes on it.

The taxpayer's employment claims in *Banks* arose under fee shifting statutes, but there was no judicial award of fees because the case settled. Had Banks gone to trial and recovered the same amounts—$314,000 from a jury verdict, followed by a fee award of $150,000—the fees would not properly be seen as income to him. The tax treatment should not be affected by the fortuity that these sums were recovered through settlement. *See EEOC v. Shell Oil Co.*, 466 U.S. 54, 77 (1984). Otherwise, plaintiffs in fee shifting cases would

be compelled to litigate, rather than settle, simply to enjoy favorable tax treatment.

A judicial award of attorneys' fees under a fee shifting statute is not income to the plaintiff, and fees recovered through settlement should be treated the same way. The judgment of the court of appeals in *Banks* can be affirmed on this ground alone. *Amici* recognize that the issue of the proper tax treatment of statutory fees was not presented to the Court by the parties, but the Court may consider arguments only put forward by an *amicus*, *Teague v. Lane*, 489 U.S. 288, 300 (1989), and *amici* request that the Court consider doing so here.

2. In addition, and in the alternative, fees received by counsel in ordinary contingent fee cases should not be deemed the plaintiff's income, either. A lawyer retained on a contingent basis is in the same economic position as a joint venturer, "in effect a cotenant of the property represented by the plaintiff's claim." Richard Posner, *Economic Analysis of Law* (5th ed. 1998) at 625. See *Banks*, 345 F.3d at 384-85. A joint venture is a "partnership" under the Tax Code, 26 U.S.C. § 761(a), and partners are taxed only on their respective "share of partnership gross income." 26 U.S.C. § 61(a)(13).

Unlike a commissioned salesperson, a lawyer paid on a contingent fee basis—if successful—significantly enhances the value of the underlying property (*i.e.*, the plaintiff's claim). And unlike counsel paid on an hourly basis, a contingent fee lawyer assumes the risk that the venture may not succeed.

In short, a successful lawyer operating under a contingent fee agreement *both* enhances the value of property and assumes the risk that the property may not be profitable. In these respects, the lawyer is in the same economic position as the owner of the property, whether or not a formal co-tenancy relationship exists. Tax law should recognize this economic

reality and treat a contingent fee arrangement as a joint venture, in which the parties are taxed only on their respective shares of gross income. Both *Banaitis* and *Banks* can be affirmed on this basis.

ARGUMENT

I. ATTORNEYS' FEES RECEIVED BY COUNSEL IN STATUTORY FEE CASES ARE NOT INCOME TO THE PLAINTIFF

An ordinary contingent fee case is "contingent" because counsel is compensated only if the plaintiff prevails following trial or if the case settles; the lawyer takes a percentage of the jury award (or settlement). The archetypal case under a fee shifting statute is also contingent in the sense that counsel is not compensated unless the plaintiff prevails. But counsel's fee does not come from the plaintiff's recovery; rather, responsibility for payment of the fee is "shifted" to the defendant, and the amount is determined by the court in a separate proceeding after the plaintiff has prevailed on the merits.

A. The Private Attorney General

Statutory fee shifting is a relatively recent phenomenon. The first modern fee shifting provisions were contained in Titles II and VII of the Civil Rights Act of 1964. *See* 42 U.S.C. § 2000a-3(b) (Title II), 42 U.S.C. § 2000e-5(k) (Title VII). Twelve years later, the Civil Rights Attorney's Fees Awards Act of 1976, 42 U.S.C. § 1988, broadened the sweep of statutory fee shifting to embrace a host of other civil rights laws.

This Court has said that the "aim" of the fee shifting provisions in Title VII and other statutes, such as 42 U.S.C. § 1988, is to encourage meritorious litigation by "enabl[ing] civil rights plaintiffs to employ reasonably competent lawyers without cost to themselves if they prevail." *Venegas v. Mitchell*, 495 U.S. at 86. In the first case construing the fee

provisions in the Civil Rights Act of 1964, the Court explained that a private plaintiff in a civil rights case acts "as a 'private attorney general,' vindicating a policy that Congress considered of the highest priority." *Newman v. Piggie Park Enterprises, Inc.*, 390 U.S. at 402. Fee shifting is essential to this enterprise because,

> [i]f successful plaintiffs were routinely forced to bear their own attorneys' fees, few aggrieved parties would be in a position to advance the public interest. . . . Congress therefore enacted the provision for counsel fees—not simply to penalize litigants . . . but, more broadly, to encourage individuals injured by racial discrimination to seek judicial relief . . . .

Id.

The Court has also construed 42 U.S.C. § 1988 in a number of cases and has said that "[t]he standards set forth [under § 1988] are generally applicable in all cases in which Congress has authorized an award of fees to a 'prevailing party.' " *Hensley v. Eckerhart*, 461 U.S. 424, 433 n.7 (1983). And the objective of § 1988 (and hence of any fee shifting statute) is to produce "fees which are adequate to attract competent counsel, but which do not produce windfalls to attorneys." *Blum v. Stenson*, 465 U.S. at 893-94. In particular, statutory fees are not intended to liquidate any private debt that the plaintiff may owe counsel. *Venegas v. Mitchell*, 495 U.S. at 90 ("§ 1988 controls what the losing defendant must pay, not what the prevailing plaintiff must pay his lawyer").

B. The Tax Problem in Statutory Fee Cases

In fee shifting cases, the trial is concerned solely with the merits. If the plaintiff wins, due either to a jury verdict or a bench ruling, the district court later considers an application for attorneys' fees from plaintiff's counsel. In fact, the judgment on fees is so divorced from the merits—so

"ancillary"—that the absence of a decision on fees does not deprive the underlying merits judgment of finality for purposes of appeal. *See White v. New Hampshire Dept. of Employment Security*, 455 U.S. 445 (1982).

There is no dispute that an award of statutory attorneys' fees is income to counsel and should be taxed accordingly. The Internal Revenue Service, however, views cases involving statutory fees in the same way it sees ordinary contingent fee cases, taking the position that *all* money paid by the defendant in a statutory fee case, including the fees themselves, is also income to the plaintiff. Hence the same fees are taxed as income to both plaintiff and counsel.

If fees were deductible in full for Federal income tax purposes, their treatment as income would be a moot point. But they are not. The IRS has successfully argued that fees should be treated as "miscellaneous itemized deductions," *see Biehl v. Commissioner*, 351 F.3d 982 (9th Cir. 2003), and under the regular income tax, such deductions are deductible only to the extent that their total exceeds two percent of adjusted gross income. 26 U.S.C. § 67. In addition, the regular income tax imposes a ceiling on miscellaneous itemized deductions. 26 U.S.C. § 68. Together, these two provisions serve to increase the nominal marginal tax rate by five percent (*e.g.*, a marginal rate of 39.6 percent effectively becomes 41.58 percent). *See* Laura Sager & Stephen Cohen, "How the Income Tax Undermines Civil Rights Law," 73 *S. Cal. L. Rev.* 1075, 1084-85 and n.52 (2000).[3]

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[3] Professor Cohen has filed an *amicus* brief here as an academic *pro se*, arguing that attorneys' fees should be considered unreimbursed employee business expenses under 26 U.S.C. § 62(a)(2)(A), rather than miscellaneous itemized deductions. Given this characterization, fees would be excluded from gross income under 26 C.F.R. § 1.62-2(c)(4) (2004). Professor Cohen proposes a simple and elegant solution to the problems associated with the taxation of attorneys' fees, and *amici* endorse his approach.

Even more egregious, the Alternative Minimum Tax (AMT), which taxpayers must compute and pay if it yields a higher tax levy than the regular income tax, does not allow any miscellaneous itemized deductions at all. 26 U.S.C. § 56(b)(1)(A)(i). That means that those prevailing plaintiffs who are subject to the AMT will owe taxes equal to either 26 or 28 percent of the court-ordered fee award. 26 U.S.C. § 55(b)(1)(A)(i). At a minimum, this will sharply cut into the recovery on the merits (which is also subject to taxation). *See* Sager & Cohen, *supra*, at 1077-78.

In ordinary contingent fee litigation, the fee can never be larger than the merits recovery, since counsel's fee is computed as a percentage of that amount. But in statutory fee cases, it is not unusual for a fee award to be larger than the merits judgment. *City of Riverside v. Rivera*, 477 U.S. 561.[4] And in cases where the amount of attorneys' fees exceeds the plaintiff's recovery, the taxes due on fees frequently will result in a net financial loss for the plaintiff. *See* Adam Liptak, "Tax Bill Exceeds Award to Officer in Sex Bias Case," *New York Times* (August 11, 2002) at A12 (recounting how a prevailing plaintiff, whose jury verdict of $3 million had been reduced to $300,000 and whose lawyers were awarded fees of $850,000, faced a net post-tax loss of $99,000).

In such cases, the plaintiff is financially worse off prevailing than losing. This is also true in cases where injunctive relief is the primary, or sole, remedy sought, as in a suit brought to enjoin use of selection devices that are not job-related but that fall more harshly on African Americans than on whites. *See Griggs v. Duke Power Co.*, 401 U.S. 424 (1971). In similar

[4] The phenomenon of attorneys' fees exceeding the merits recovery is especially likely under Title VII and the Americans with Disabilities Act, where damages are capped at $300,000 for even the largest employers under 42 U.S.C. § 1981a(b)(3), so larger jury verdicts are routinely reduced to $300,000.

fashion, there may be no pay loss in a case of sexual harassment, and the victimized woman may simply want the security of a judicial prohibition. And even if she also seeks damages, an injunction may still be the most potent remedy available against small employers (100 or fewer employees), where the damage ceiling is $50,000. 42 U.S.C. § 1981a(b)(3). Treating the fees awarded counsel as income to the plaintiff in such cases, and taxing the plaintiff on that sum, eviscerates the congressional objective of permitting plaintiffs "to employ . . . lawyers without cost to themselves if they prevail." *Venegas v. Mitchell*, 495 U.S. at 86. Indeed, such tax treatment would deter citizens from pursuing even the most meritorious civil rights claims.

C. The Assignment of Income Doctrine Does Not Apply to Statutory Fees

At the outset of his Summary of Argument, the Solicitor General makes a number of points that he believes apply to the ordinary contingent fee setting, but none of them are pertinent to statutory fees. For example, the Solicitor General says that "income is to be taxed to the person who earns it, even when it is paid at that person's direction to someone else," Brief for Petitioner at 11; that "when a debt owed by a taxpayer is satisfied by a direct payment from a third party to the taxpayer's creditor, the taxpayer receives 'income' in the amount of the discharged debt," *id.*; and that where a taxpayer "has 'divert[ed] the payment from himself to others as the means of procuring the satisfaction of his wants,' [he] is subject to tax on the diverted proceeds," *id.* *Amici* do not quarrel with these tenets, but they do not apply to judicial awards under a fee shifting statute.

1. *The Assignment of Income Doctrine*

The principles cited by the Solicitor General represent differing formulations of the anticipatory assignment of income doctrine, which the Court developed in the first

generation following the adoption of the Federal income tax to prevent taxpayers from escaping taxation through shell games. For example, in *Lucas v. Earl*, 281 U.S. 111 (1930), the Court declined to bless a scheme in which a taxpayer assigned 50 percent of his future salary to his wife in an effort to avoid paying taxes on the entire amount. *Id.* at 115 (rejecting an "arrangement by which the fruits are attributed to a different tree from that on which they grew").

Similarly, in *Helvering v. Horst*, 311 U.S. 112 (1940), the Court held that the taxpayer was liable for taxes due on interest from bonds that he held, even though he had clipped the interest coupons and given them to his son shortly before the maturity date. And in *Horst*, the Court noted that it had previously ruled, in another variation on the assignment of income theme, that "[i]f the taxpayer procures payment directly to his creditors of the items of interest or earnings due him * * * he does not escape taxation because he did not actually receive the money." *Id.* at 116. That is, "[i]f A owes B a debt, and C pays the debt on A's behalf, it is elementary that C's payment is income to A as well as to B." *Sinyard v. Commissioner*, 268 F.3d 756, 758 (9th Cir. 2001), *cert. denied*, 538 U.S. 904 (2002).

2. *The Inapplicability of the Doctrine to Statutory Fees*

The principles first enunciated in *Lucas v. Earl* and *Helvering v. Horst* do not apply to the statutory fee context. A defendant who pays a court-ordered fee award, for example, is not discharging a private debt owed by the plaintiff to counsel, since fees awarded by a court are divorced from any private understanding between plaintiff and her lawyer. Thus, even nonprofit organizations that provide legal services *pro bono* are entitled to fees if the plaintiff prevails. *Blum v. Stenson*, *supra* (Legal Aid Society of New York City entitled to fees).

In addition, the amount of the fee award has nothing to do with whatever private agreement plaintiff and counsel may (or may not) have. *See Blanchard v. Bergeron*, 489 U.S. at 93 ("[s]hould a [private] fee agreement provide less than a reasonable fee . . . the defendant should nevertheless be required to pay the higher amount. The defendant is not, however, required to pay the amount called for in a contingent-fee contract if it is more than a reasonable fee"); *Venegas v. Mitchell*, 495 U.S. at 90 ("§ 1988 controls what the losing defendant must pay, not what the prevailing plaintiff must pay his lawyer").

Rather than depending on a private arrangement, the fee award should be a sum "adequate to attract competent counsel, but which do[es] not produce windfalls to attorneys." *Blum v. Stenson*, 465 U.S. at 893-94. In practice, this means that the award should be calibrated to reflect the lawyer's effort; *i.e.*, "[t]he most useful starting point for determining the amount of a reasonable fee is the number of hours reasonably expended on the litigation multiplied by a reasonable hourly rate." *Hensley v. Eckerhart*, 461 U.S. at 433. The Solicitor General says that the " 'source of the income' at issue" is a salient factor in determining who should be taxed, Brief for Petitioner at 12 (*quoting Horst*, 311 U.S. at 116), and *Hensley* makes it clear that the "source" of the fee award—in particular, its amount—is the lawyer's effort, not the plaintiff's.

In a statutory fee case, unlike ordinary contingent fee litigation, two distinct sums are generated. The first is the judgment on the merits. Then, in a separate proceeding, attorneys' fees are awarded by the court. Unlike ordinary contingent fee litigation, the plaintiff's lawyer has no claim under fee shifting laws to any portion of the judgment on the merits. By the same token, Congress did not envision that the plaintiff herself would retain the attorneys' fees awarded in the separate fee proceeding.

The difference between private contingent fee arrangements and statutory fee shifting is highlighted in *pro se* cases, where retained lawyers are absent. If the plaintiff in a common law tort action decides to represent herself rather than retain counsel on a contingent basis, and if she then prevails on the merits, she gets to keep the entire judgment, including the portion that might otherwise have gone to a lawyer. But in a case subject to a fee shifting law, a *pro se* plaintiff who prevails is entitled only to the merits judgment and is never eligible for a separate fee award. This is true even if the *pro se* plaintiff is a lawyer, since fees are awarded only to further the congressional goal of attracting retained counsel. *Kay v. Ehrler*, 499 U.S. 432.

This is not to suggest that lawyers have a property interest in fees under fee shifting laws. They do not. Hence the plaintiff in a statutory fee lawsuit (as in any other case) has the final say on all substantive matters. This is why the plaintiff (in the absence of a private agreement with counsel) is free to bargain away fees in exchange for greater relief on the merits. *See, e.g., Evans v. Jeff D.*, 475 U.S. 717, 731-32 (1986). *Jeff D.*, however, deals with control of the litigation. If fees are ultimately awarded, however, they go to counsel; the plaintiff has no statutory claim on the money. *Kay v. Ehrler*, *supra*.

In *Helvering v. Horst*, the Court said that "[c]ommon understanding and experience are the touchstones for the interpretation of the revenue laws." 311 U.S. at 118. This sentiment may have been aspirational, but on any "common understanding," the plaintiff in a statutory fee case does not receive income through court-ordered fees.

D. Porter v. AID

Amici believe that only one court has squarely addressed the issue of the taxability of an award of attorneys' fees in the statutory fee context. In *Porter v. Director, Agency for International Development*, 293 F.Supp.2d 152, the jury found that the plaintiff had twice been denied promotions because of retaliation in violation of Title VII, and awarded a total of $30,000 in damages. In a separate proceeding, the district court later awarded $253,987 in attorneys' fees. *See* No. 00-1954 (D.D.C.), Docket Entry No. 155 (December 12, 2003).

If the IRS' position prevails and both the damages and fees awarded in *Porter* are seen as income to the plaintiff, he would in all likelihood be subject to the Alternative Minimum Tax. And since the IRS views fees as "miscellaneous itemized deductions" which are not deductible under the AMT (and since the AMT has only two brackets—26 and 28 percent), the plaintiff will owe either 26 or 28 percent of $283,987 (the total of $253,987 in fees and $30,000 in damages). That is, he will owe either $73,837 (at 26 percent) or $79,516 (at 28 percent). But the plaintiff did not receive any of the fee award; his counsel did. The plaintiff received only $30,000 in damages, so his net loss will be $43,837 or $49,516. He would have been much better off financially if he had lost on the merits at trial. Such pyrrhic victories will frustrate the congressional goal of encouraging private citizens to vindicate civil rights.

The district court in *Porter* was plainly troubled by this prospect. And given Title VII's "make whole" imperative, the court was confident that it possessed authority—if necessary—to order that the fee award be "grossed up" to ameliorate any adverse tax consequences. 293 F.Supp.2d at 156.[5] The district court declined to order grossing up,

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[5] Other courts have agreed that they have authority under anti-discrimination statutes to enhance awards to mitigate adverse tax consequences. *See, e.g., Sears v. Atchison, Topeka & Santa Fe Ry. Co.*, 749 F.2d 1451, 1456 (10th Cir. 1984) (Title VII); *Jordan v. CCH, Inc.*, 230 F.Supp.2d 603, 617 (E.D. Pa. 2002) (Age Discrimination in Employment Act); *O'Neill v. Sears Roebuck & Co.*, 108 F.Supp.2d 443, 446-47 (E.D.

however, due to considerations of finality and also because of a belief that—in the end—the award of attorneys' fees would not be deemed income to the plaintiff. *Id.* Instead, the court "concluded that the best course is to do what [it] can to ensure that the attorneys' fee award never becomes a tax problem for Porter, by . . . explaining the nature of the award clearly, so that Porter or his tax adviser can refer to the explanation when preparing income tax returns, and so that the IRS can consider the explanation before attempting to impose a tax on Porter for the attorney's fee award." *Id.* at 157.

In its "explanation" for the IRS, the district court said that "[t]he plaintiff's attorney in a Title VII case performs a public interest role," and that Congress authorized fee shifting "because it recognized that incentives would be needed to bring lawyers into a controversial field, where recoveries might not otherwise warrant substantial fees, in order to vindicate newly enacted civil rights." *Id.* The court further explained that "[a]n award of attorneys' fees in a Title VII case is not a percentage, or a subset, or in any way a part of an award of compensatory damages or of an award of back pay, front pay, or pre-judgment interest given as equitable relief." *Id.* Rather, "[i]t is a separate award, separately provided by statute, and made by the court in a separate proceeding." *Id.*

For these reasons, "[t]he ownership issue that appears to have split the circuits on the taxability of contingent fees . . . is not germane to a statutory Title VII attorneys' fee, and neither is the assignment of income doctrine." *Id.* at 158. That is, "the *form* of an attorneys' fee award is that of an

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Pa. 2000) (ADEA); *EEOC v. Joe's Stone Crab, Inc.*, 15 F.Supp.2d 1368, 1380 (S.D. Fla. 1998) (Title VII); *Arneson v. Sullivan*, 958 F.Supp. 443, 447 (E.D. Mo. 1996) (Rehabilitation Act). *See also Blaney v. IAM*, 87 P.3d 757, 761-64 (S.Ct. Wash. 2004) (Washington Law Against Discrimination). *But see Dashnaw v. Pena*, 12 F.3d 1112 (D.C. Cir. 1994).

award made to the prevailing party, [but] in *substance* the award is to counsel." *Id.* (emphasis in original).

Porter is on appeal on the merits, *Porter v. Natsios*, No. 04-5061 (D.C. Cir.), so the plaintiff's tax liability has not yet been determined. But the case is instructive in illustrating the serious tax consequences that can befall a plaintiff who prevails in a Title VII case, as well as pointing to a way out of this dilemma. The solution proposed by the district court in *Porter*, and advocated in this *amicus* brief, harmonizes important tax rules with equally compelling principles of civil rights law.[6]

E. The Effect of Statutory Fee Shifting on Banks

The taxpayer in *Banks* settled his employment case through an arrangement in which the defendant paid $464,000, of which $314,000 went to Banks himself and $150,000 to his lawyer. At the time of settlement, Banks had three viable claims under three different statutes—Title VII, 42 U.S.C. § 1981 and 42 U.S.C. § 1983—and all three were subject to statutory fee shifting. 42 U.S.C. § 2000e-5(k) (Title VII), and 42 U.S.C. § 1988 (§§ 1981, 1983). It does not matter for tax purposes if fees are recovered by judicial order or through settlement.

In any case subject to fee shifting, settlement discussions invariably include the amount of fees at issue, since this is part of the defendant's exposure. Consequently, any

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[6] As the district court noted in *Porter*, 293 F.Supp.2d at 154, a legislative solution would be welcome, but to date none has been forthcoming. Most recently, the Senate in May 2004 passed S. 1637, the Jumpstart Our Business Strength (JOBS) bill, which includes a provision (§ 643) that permits "above the line" deductions of attorneys' fees awarded or paid in cases involving employment disputes, so that such fees would not be included in Adjusted Gross Income subject to taxation. The House bill, H.R. 4520, contains no such provision, and there has been no conference as of the filing of this brief.

settlement includes—either explicitly or (frequently) implicitly—a sum devoted to fees. In these circumstances, there should be no difference in the tax treatment accorded fees awarded by a court or received by counsel as part of a settlement.

This Court has repeatedly observed that congressional policy favors the amicable resolution of Title VII disputes, as opposed to resolution on the merits following contested litigation. *See Burlington Industries, Inc. v. Ellerth*, 524 U.S. 742, 764 (1998) (noting "Congress' intention to promote conciliation rather than litigation in the Title VII context," and citing *EEOC v. Shell Oil Co.*, 466 U.S. 54, 77 (1984)). This pro-settlement policy would be undermined if a Title VII plaintiff could secure favorable tax treatment of the fees paid to counsel only by going to trial. *See Porter v. AID*, 293 F.Supp.2d at 155-56 (if "[c]ivil rights plaintiffs who settle their claims but are obligated to pay their attorneys fees under contingency agreements are treated just like other civil litigants under the assignment of income doctrine . . . such a result [would be] in direct conflict with the underlying purpose of the fee shifting provisions applicable to civil rights litigation").

In any event, Congress has shown that it believes that sums received through settlement should be treated the same way, for tax purposes, as amounts recovered through resolution on the merits. *See, e.g.*, 26 U.S.C. § 104(a)(2) (gross income does not include "the amount of any damages (other than punitive damages) received (*whether by suit or agreement* . . .) on account of personal physical injuries or physical sickness") (emphasis added).

It is possible that the amount received by counsel through settlement of a Title VII (or other statutory fee) claim would be greater than what a court might award; it also might be less. But these vagaries are true of all aspects of a settlement, including the sum recovered by the plaintiff. If in a particular

case the IRS believed that the amount received by counsel through settlement materially exceeded any possible court award of fees—and if the Service further believed that the increment should be seen as income to the plaintiff—then the amount allocated to fees could be challenged. The IRS often challenges such taxpayer characterizations; indeed, it was successful in *Banks* itself in contesting the plaintiff's effort to characterize his settlement recovery as "personal injury damages" rather than lost wages. 345 F.3d at 381-82.[7]

Had the plaintiff in *Banks* received $314,000 from a jury verdict, followed by a fee award of $150,000, the fees would not properly be seen as income to the taxpayer. The tax treatment is not affected by the fortuity that these amounts were recovered through settlement.

Amici understand that the taxpayer in *Banks* did not advance below the argument made here. The Court may, however, consider arguments only presented by *amici*, *Teague v. Lane*, 489 U.S. at 300; *Mapp v. Ohio*, 367 U.S. 643, 646 n.3 (1961), and the judgment of the court of appeals in *Banks* can be affirmed on the ground that statutory fees are not included in the plaintiff's income.

II. ORDINARY CONTINGENT FEES ARE NOT INCOME TO THE PLAINTIFF

The first issue in this case—whether fees received by counsel represent income to the plaintiff in statutory fee cases—is not a close question. They do not. The result is the same for the remaining issue—whether fees received by

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[7] Any IRS challenge to the amount allocated to attorneys' fees in a Title VII settlement would make sense only in a tax regime in which (1) fees received by counsel under fee shifting statutes are *not* deemed income to the plaintiff, but (2) fees received by counsel in ordinary contingent fee litigation *are* treated as the plaintiff's income. As is shown below, however, fees received by counsel in ordinary contingent fee cases should not be considered income to the plaintiff, albeit for different reasons than in the statutory fee context.

counsel in ordinary contingent fee litigation should be deemed the plaintiff's income—although the analysis differs. Attorneys' fees are not income to the plaintiff in either situation.

A. The Split in the Circuits

The courts of appeals have divided over the treatment of counsel fees in the ordinary, non-fee shifting context. Five circuits agree with the IRS and see fees as income to the plaintiff, on an assignment of income rationale. *Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004), *petition for cert. pending*, No. 03-1415; *Young v. Commissioner*, 240 F.3d 369, 376-79 (4th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3d 881 (7th Cir. 2001); *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312 (10th Cir. 2001), *cert. denied*, 535 U.S. 1056 (2002); *Baylin v. United States*, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995).

Three other circuits have rejected the IRS position and have held that the portion of a judgment due counsel as a contingent fee is not income to the plaintiff. *Cotnam v. Commissioner*, *supra*; *Srivastava v. Commissioner*, 220 F.3d 353, 364-65 (5th Cir. 2000); *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Banks*, *supra* (6th Cir. 2003); *Davis v. Commissioner*, 210 F.3d 1346 (11th Cir. 2000) (*per curiam*); *Foster v. United States*, 249 F.3d 1275, 1279-80 (11th Cir. 2001). The Fifth and Eleventh Circuit stress that counsel was entitled under state law to an ironclad lien on his share of the proceeds, while the Sixth has moved from a primary focus on state lien law in *Estate of Clarks* to a more universal approach in *Banks* that likens the contingent fee arrangement to a joint venture in which the lawyer has a percentage interest.

The Ninth Circuit has conflicting decisions, depending in part on its reading of lien law in different states. *Compare Banaitis*, *supra* (9th Cir. 2003) (fees received by counsel are

not income to the plaintiff), *with* cases reaching the opposite result: *Benci-Woodward v. Commissioner*, 219 F.3d 941, 944 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); *Coady v. Commissioner*, 213 F.3d 1187 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); *Sinyard v. Commissioner*, *supra*.

B. The Dispositive Nature of the Joint Venture Analogy

As noted, *Banks* analogized a contingent fee agreement to a joint venture. A joint venture is a type of partnership for tax purposes, 26 U.S.C. § 761(a), and partners realize income only on their "[d]istributive share of partnership gross income." 26 U.S.C. § 61(a)(13); *see* 26 U.S.C. § 702. Hence, if a contingent fee arrangement is seen as akin to a joint venture, the plaintiff will realize income only on her share of the court award (or settlement); in particular, fees received by counsel will not be deemed income to the plaintiff.

Also in *Banks*, the court eschewed reliance on state lien law, saying that, "[g]iven the various distinctions among attorney's lien laws among the fifty states . . . a 'state-by-state' approach would not provide reliable precedent . . . or provide sufficient notice to taxpayers as to [the] tax treatment of contingency-based attorneys fees paid from their respective jury awards." 345 F.3d at 385. Under a global approach, the issue is whether an ordinary contingent fee relationship is more like an assignment of income or a joint venture. If the former, the lawyer's share is properly treated as income to the plaintiff. But if the relationship is more like a joint venture, the share received by counsel is only counsel's income—not the plaintiff's. In fact, the essential attributes of a joint venture are present in the contingent fee relationship.[8]

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[8] If it is thought preferable to address the tax consequences of contingent fee agreements on a "state-by-state" basis, *amici* believe that the Ninth Circuit in *Banaitis* properly analyzed the tax treatment that flows from Oregon lien law.

1. *Kenseth*

Judge Posner's opinion in *Kenseth, supra,* is the best articulation of the assignment of income perspective on contingent fee agreements, so the decision warrants careful examination. *Kenseth* first describes the tax problem faced by the taxpayer, which was aggravated but not entirely caused by the AMT. 259 F.3d at 882. The decision then notes that "[t]he circuits are split on whether a contingent fee is, as the Tax Court held in this case, a part of the client's taxable income," *id.* at 883 The opinion agreed with the Tax Court, *id.*, reasoning that a contingent-fee lawyer's share of a recovery should be seen as a business expense for the plaintiff. *Id.* It is simply unfortunate if the tax code does not permit full (or any) deduction of this expense. *Id.*[9]

[9] Judge Posner notes at the outset of *Kenseth* that the taxpayer's underlying case dealt with age discrimination. 259 F.3d at 882. The Age Discrimination in Employment Act provides for statutory attorneys' fees, *see* 29 U.S.C. § 626(b) (incorporating among other things the fee shifting provisions in 29 U.S.C. § 216(b)), but *Kenseth* does not address the singularities of statutory fee litigation and instead assumes that it is dealing with an ordinary contingent fee case.

Only three of the other circuit decisions cited above arose under laws permitting fee shifting—*Banks* itself, *Hukkanen-Campbell* (Title VII), and *Sinyard* (ADEA). As in *Banks* (and *Kenseth*), the Tenth Circuit in *Hukkanen-Campbell* did not acknowledge that statutory fees were in the picture. The Ninth Circuit in *Sinyard* undertook a cursory examination of this issue. After saying that, "[i]f A owes B a debt, and C pays the debt on A's behalf, it is elementary that C's payment is income to A as well as to B," 268 F.3d at 758, the majority simply observed that fee awards are formally bestowed on the plaintiff, not counsel, *id.* at 759, *citing Evans v. Jeff D.* and *Venegas v. Mitchell.* As the dissent noted, though, *Jeff D.* and *Venegas* "were decided in a different context—namely, client control over the resolution of a case." *Id.* at 761 n.2. The dissent properly concluded that, "[h]ere, defendant C does not satisfy a debt on behalf of plaintiff A; rather, C satisfies its own statutory obligation, imposed by the ADEA." *Id.* at 762.

In *Kenseth*, the taxpayer's underlying claim arose in Wisconsin and, relying on Wisconsin lien law, he argued that the lawyer was a co-owner of the underlying claim. Were that true, the lawyer's share of a recovery would merely be her entitlement as co-owner; it would not be the plaintiff's business expense. But *Kenseth* quickly disposed of any argument about co-ownership grounded on Wisconsin lien law. *Id.* at 884.

In the end, *Kenseth* concluded that "what [the taxpayer] really is asking us to do is to assign a portion of *his income* to the law firm." *Id.* (emphasis in original). And that does not work: "an assignment of income . . . by a taxpayer is ineffective to shift his tax liability." *Id., citing Lucas v. Earl,* 281 U.S. at 114-15.

2. *The Economic Realities*

The Solicitor General, who addresses only the ordinary contingent fee situation, acknowledges that the ultimate tax question is one of reasonableness—whether it is "reasonable to treat the entire award[] as gross income" to the plaintiff. Brief for Petitioner at 13. Reasonableness, in turn, is a function of the practical realities of a situation. And despite its holding, *Kenseth* helps to reveal the economic reality that a contingent fee arrangement is a joint venture for tax purposes. As the decision rightly says, though, this has nothing to do with state lien law.

Rather, as Judge Posner acknowledged in *Kenseth*, "there is a sense in which contingent compensation constitutes the recipient a kind of joint venturer of the payor." 259 F.3d at 883. He elaborated on this point in his book, *Economic Analysis of Law*, saying a contingent fee agreement is a "situation of joint ownership," because "a contingent fee contract makes the lawyer in effect a cotenant of the property represented by the plaintiff's claim." *Id.* at 625 (parentheses omitted).

Consider a tract of land which, undeveloped, has a low value. The owner of the land enters into an agreement with a developer, in which the developer agrees to improve the land by putting in roads and a sewage system and building houses, and in which the parties agree to apportion income from the developed land on a 60-40 basis, with the developer entitled to 40 percent. In this joint venture, the parties (the land owner and the developer) realize income only on their respective "distributive share[s]" of the gross income from the developed land. *See* 26 U.S.C. §§ 61(a)(13), 761(a).

Now, assume that a salesperson is hired to sell the houses on a commission basis, *i.e.*, a percentage of the sales price of each house. As *Kenseth* correctly says, "the sales income [the salesperson] generates is income to the [owner/developer] and his commissions are a deductible expense, even though they were contingent on his making sales." 259 F.3d at 883.

The examples of the developer and salesperson show that a contingent compensation arrangement, by itself, is insufficient to indicate whether the compensation received is properly considered a business expense of the owner—and hence part of the owner's income. But if the contingent nature of compensation does not explain the difference in tax treatment as between the developer and the salesperson, then what is the explanation? The Sixth Circuit in *Banks*, harkening back to the language of *Lucas v. Earl* and *Helvering v. Horst*, says that—with respect to the developer—the landowner "transferred some of the trees from the orchard, rather than simply transferring some of the orchard's fruit." 345 F.3d at 386.

The metaphor used in *Banks* is not particularly illuminating. Instead, one salient difference between the developer and the salesperson is that the developer took significant steps to enhance the value of the property. In contrast, the salesperson simply sold pieces of the land; he did nothing to

increase its value. The developer creates wealth; the salesperson does not.

3. *The Contingent Fee Lawyer as Joint Venturer*

A contingent fee lawyer is like the developer in the examples above. The lawyer's task is to enhance the value of property—to take an undeveloped claim and to improve it, so that a jury will place a fully compensatory value on it.

Of course, a landowner can hire a developer at a fixed rate and finance the development himself, rather than entering into a joint venture agreement. If so, the compensation paid to the developer is properly seen as a business expense of the owner. But if for economic reasons—*e.g.*, a lack of money to finance development—the owner elects to make the developer a joint venturer, then the developer assumes part of the risk. And if this happens, the compensation ultimately received by the developer (assuming the enterprise is successful) is not the landowner's business expense. Under the Tax Code, it is income solely to the developer. 26 U.S.C. § 61(a)(13).

In the same way, the holder of a legal claim may retain a lawyer on an hourly basis. If this occurs, the compensation received by the lawyer is properly seen as the claimholder's expense. But if the claimholder lacks the money to finance litigation and desires to share the risk, she may enter into a contingent fee agreement with counsel. If so, the compensation ultimately received by counsel (if the lawsuit is successful) is not the claimholder's business expense and is income solely to counsel.

A developer retained at a fixed rate, like a lawyer retained on an hourly basis, may engage in wealth creation by improving property. But only the developer as joint venturer, and the contingent fee lawyer, *both* (1) create wealth, and (2) assume risk. One who both enhances the value of property, and who assumes the risk that the property may not be

profitable, is in the same economic position as the owner of the property, whether or not a formal co-tenancy relationship exists. Tax law should recognize the economic reality that a lawyer retained on a contingent basis is "in effect a cotenant of the property represented by the plaintiff's claim." *Economic Analysis of Law, supra,* at 625.[10]

On the one hand, a contingent fee agreement shares the essential attributes of a joint venture—wealth creation and assumption of risk. On the other, there are important differences between contingent fee arrangements and the devices that have been seen as mere assignments of income. For example, contingent fee agreements are animated not by tax avoidance purpose but rather by economic motive. *See Economic Analysis of Law* at 624. And application of the assignment of income doctrine to the contingent fee setting results in double taxation; *i.e.*, counsel's fee is treated as income to both counsel and the plaintiff. Double taxation is not unprecedented, but it is inefficient economically and should not be indulged without the type of clear signal from Congress that is lacking here. *See Banks*, 345 F.3d at 385-86.

Ordinary contingent fee agreements are much closer to joint ventures than to the schemes interdicted by the assignment of income doctrine. Attorneys' fees received by contingent fee counsel should not be treated as income to the plaintiff.

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[10] *Kenseth* notes that fees paid to a lawyer retained on an hourly basis are treated as the plaintiff's expense and says, "[w]e cannot see what difference" a contingent fee arrangement makes. 259 F.3d at 883. The difference is counsel's assumption of risk, which leads to a fundamental lack of symmetry: the hourly lawyer is entitled to payment for his services even if he loses. But if the contingent fee lawyer loses, she is not entitled to payment, and she cannot take a business loss deduction in connection with her unreimbursed services.

CONCLUSION

A judicial award of attorneys' fees under a fee shifting statute is manifestly not income to the plaintiff. The same is true of fees recovered as part of a settlement of a claim subject to fee shifting. The judgment of the Sixth Circuit in *Banks* can be affirmed on this ground alone.

In addition, fees received by counsel in all contingent fee cases, even those that do not arise under fee shifting statutes, should not be deemed income to the plaintiff, either, because contingent fee agreements are materially the same as joint ventures. The judgments in both *Banks* and *Banaitis* can be affirmed on this ground.

The judgments of the courts of appeals should be affirmed.

Respectfully submitted,

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APPENDIX

The National Employment Lawyers Association (NELA) is the only professional membership organization in the country comprised of lawyers who represent employees in labor, employment and civil rights disputes. NELA and its 67 state and local affiliates have a membership of over 3,000 attorneys who are committed to working on behalf of those who have been victims of wrongful termination and unlawful employment discrimination. NELA strives to protect the rights of its members' clients, and regularly supports precedent-setting litigation affecting the rights of individuals in the workplace. NELA's members represent clients under all the fee shifting statutes set forth in the Statement of Interest.

The NAACP Legal Defense and Educational Fund, Inc. ("LDF") is a non-profit corporation established under the laws of the State of New York. It was formed to assist black persons in securing their constitutional and statutory rights through the prosecution of lawsuits and to provide legal services to black persons suffering injustice by reason of racial discrimination. For six decades LDF attorneys have represented parties in litigation before this Court and the lower federal courts involving race discrimination, specifically including race discrimination in employment. *See, e.g., Griggs v. Duke Power Co.*, 401 U.S. 424 (1971); *Albemarle Paper Co. v. Moody*, 422 U.S. 405 (1975); *Franks v. Bowman Transp. Co.*, 424 U.S. 747 (1976); *Bazemore v. Friday*, 478 U.S. 385 (1986); *Robinson v. Shell Oil Co.*, 519 U.S. 337 (1997). LDF also represented the successful plaintiff in the case that established the basic standard for awarding fees under federal fee-shifting statutes, *Newman v. Piggie Park Enterprises, Inc.*, 390 U.S. 400 (1968), and it has frequently appeared before this Court as *amicus curiae* in matters involving the construction of federal civil rights laws.

AARP is a nonpartisan, nonprofit membership organization of more than 35 million people aged 50 or older dedicated to

addressing the needs and interests of older Americans. AARP supports and defends the rights of older Americans and the laws and public policies designed to protect them. Approximately one half of AARP's members remain active in the work force and are protected by one or more federal fee-shifting statutes, including, *inter alia*, the Age Discrimination in Employment Act, Title VII of the Civil Rights Act of 1964, and the Americans with Disabilities Act. Moreover, other types of litigation that involve contingent fee arrangements, including that conducted pursuant to federal and state consumer protection statutes, can be an effective mechanism to enforce the rights of older Americans involving a broad range of issues. Treating attorneys' fees, whether awarded under fee-shifting statutes or obtained pursuant to a contingency agreement, as taxable income to prevailing plaintiffs would be counterproductive to the remedial purposes of litigation. Additionally, contrary to the interests of the parties, such tax treatment would act as a disincentive to settlements and, consequently, unnecessarily burden court systems. AARP, therefore, opposes treating attorneys' fees as taxable income to prevailing plaintiffs and urges the Court to affirm the decisions below.

Trial Lawyers for Public Justice (TLPJ) is a national public interest law firm dedicated to using trial lawyers' skills and approaches to create a more just society. Through precedent-setting litigation, TLPJ prosecutes cases throughout the country designed to enhance consumer and victims' rights, environmental protection, civil rights and liberties, workers' rights, America's civil justice system, and the protection of the poor and powerless. TLPJ is committed to preserving an accessible system of justice in this country and appears as *amicus curiae* in this case because the treatment of attorneys' fees as taxable income to the client could further diminish access to the courts for those who need legal representation to enforce their rights but who cannot afford to pay competent counsel on their own.

Public Advocates, Inc., one of the oldest public interest law firms in the nation, was founded in 1971 to challenge the persistent, underlying causes and effects of poverty and discrimination and to work for the empowerment of the poor and people of color by raising a voice for social justice in government, corporate and other institutions. Public Advocates was instrumental in the recognition of the "private attorney general" doctrine in *Serrano v. Priest*, 20 Cal.3d 25 (1977), and statutory attorneys' fees continue to play an important role in enabling Public Advocates to represent poor communities and individuals today.

The Western Center on Law and Poverty is the oldest and largest state support center for California's legal services program serving the poor. The Western Center, which no longer receives federal funding, depends on court-awarded statutory attorneys' fees. In most of the Center's cases, the clients do not receive a monetary reward. The possibility that the Center's indigent clients nonetheless could owe substantial sums of money in taxes would certainly deter litigation on their behalf.

Nos. 03-892 AND 03-907

AUG 17 2004

In The
Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

JOHN W. BANKS, II,

Respondent.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

SIGITAS J. BANAITIS,

Respondent.

On Writs Of Certiorari
To The United States Courts Of Appeals
For The Sixth And Ninth Circuits

BRIEF OF *AMICUS CURIAE*, OREGON TRIAL LAWYERS ASSOCIATION, IN SUPPORT OF RESPONDENT, SIGITAS J. BANAITIS

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BRIEF OF *AMICUS CURIAE* OREGON TRIAL LAWYERS ASSOCIATION

I. INTEREST OF *AMICUS CURIAE*.

The Oregon Trial Lawyer's Association (OTLA)[1] offers this brief as *amicus curiae* in support of the respondent taxpayer, Sigitas J. Banaitis ("Banaitis").

OTLA is a statewide organization of over 1,000 trial lawyers, and 200 non-attorneys, dedicated to the preservation of the civil justice system. Its attorney members represent plaintiffs, consumers, investors, small businesses, employees, and parties in state and federal courts in the State of Oregon. OTLA members are frequently compensated on a contingent fee basis, not only in personal injury cases (which are unaffected by Alternative Minimum Tax (AMT)), but also in a wide variety of cases where AMT directly comes into play for an individual taxpayer: cases brought to vindicate employee rights under Oregon common law and discrimination statutes, consumer rights cases, cases for economic injury for homeowners, insureds and investors brought under hundreds of state statutory fee-shifting statutes, contract claims providing for the prevailing party to recover attorney fees, and in split-recovery cases, such as punitive damage claims, where litigants act as private attorneys general for the financial benefit of the State of Oregon.

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[1] In accordance with Rule 33.6, counsel for the Oregon Trial Lawyer's Association is the sole author of this brief, is a past president of the Association, and serves on its *amicus* committee. No monetary compensation was paid for the preparation of this brief other than the volunteer time and cost of printing provided by the brief's author on behalf of the Association.

OTLA has provided the Oregon appellate courts, sometimes at the court's request, with dozens, and perhaps as many as one hundred briefs as *amicus curiae* to assist the court in analyzing and articulating a correct rule of law in civil cases, including *Potter v. Schlesser,* 335 Or. 209, 63 P.3d 1172 (Or. 2003). *Potter* is the Oregon Supreme Court decision upon which the Ninth Circuit relied in reaching its decision on behalf of Banaitis.

OTLA seeks to bring to the attention of this Court relevant matters not already brought to it by the parties concerning attorneys' lien rights in Oregon, and the Oregon Rules of Professional Conduct, which set forth the economic relationship between attorney and client. Simply put: the Commissioner's proposed rule of law is based upon an incorrect interpretation of Oregon law. OTLA members have a keen interest to ensure that this Court does not misinterpret Oregon law. And an incorrect application of Oregon law in this case would have a draconian impact upon Oregon litigants.

II. SUMMARY OF THE ARGUMENT.

The Oregon Legislature has enacted an attorney lien law that expressly provides that an attorney has a charging lien upon a client's cause of action. An attorney lien is a statutory right that expressly provides an attorney with a direct ownership interest in litigation that results from the fruit of their labor in creating a judgment or settlement on behalf of a client, and differs from a mere contractual assignment of income. The Oregon Supreme Court has adopted Rules of Professional Conduct that permits an attorney to acquire an ownership interest in their client's claim only when a reasonable contingent fee has been

agreed upon in civil litigation. Therefore, under Oregon property law, attorney's fees paid to an attorney under a contingent fee that is subject to an attorney's lien is not part of the client's income.

III. ARGUMENT.

The Commissioner, in Section II B, of its brief asserts that the Ninth Circuit misapplied Oregon law, arguing that "[t]he non-proprietary nature" of Oregon's attorney's lien statute results in no direct property rights in their client's litigation when attorneys are hired on a contingent fee basis. The Commissioner's conclusion, and the very premise of its argument, is wrong.

It is a well-established principal of tax law that the property rights of a taxpayer is defined by the laws of each state, and then the federal tax laws uniformly tax those property rights. As a general rule, the existence and nature of property rights and ownership interests are questions of state law. *Aronson v. Commissioner,* 98 T.C. 283, 288 (1992) ("State law creates interests and rights; federal law determines what interests and rights shall be taxed") *citing Morgan v. Commissioner,* 309 U.S. 78, 80 (1940); *Lyeth v. Hoey,* 305 U.S. 188, 193 (1938); *Heiner v. Mellon,* 304 U.S. 271, 279 (1938); *Burnet v. Harmen,* 287 U.S. 103, 110 (1932).

The Ninth Circuit reached the correct conclusion concerning Oregon law based upon the Oregon Supreme Court decision in *Potter v. Schlesser, supra. Potter* concerned the appropriate remedies available to an Oregon attorney under the state's attorney lien statutes. The foundation for the *Potter* decision is founded upon a convergence of two sources: the nature of attorney's lien

statutes in Oregon, and the nature of the ethical rules governing the attorney-client relationship under Oregon law.

A. The Nature of an Oregon Attorney's Lien.

Contrary to the Commissioner's brief at page 39, under Oregon law an attorney's interest in her client's cause of action is not that of a mere "lienor," and an attorney's lien does not arise from an "assignment of client income."

1. An Attorney's Charging Lien Attaches Upon Commencement of the Action.

Attachment of an attorney's lien in Oregon is and has always been based on the direct interest of an attorney in her client's litigation arising from the attorney's "charging lien." An attorney representing a client who has commenced litigation has long possessed a "charging lien" upon her client's cause of action, which necessarily provides the attorney with a property interest in the litigation itself under Oregon law.

Before Oregon's first statutory code, the Deady Code, was enacted in 1862, Oregon recognized the common law right of an attorney to enforce a charging lien against her client's action, judgment and settlement. *Day v. Larsen*, 30 Or. 247, 248 47 Pac. 101 (Or. 1896) ("The right to acquire the lien is a privilege of which the attorney may avail himself . . . "). English courts recognized an attorney's charging lien as an equitable right of an attorney to be paid directly out of the judgment entered on behalf of a client. *Welch v. Hole,* 1 Doug. 238, 99 Eng. Rep. 155 (1779) (Lord Mansfield). Charging liens were well known during colonial times. *See generally,* Note, *Attorney's Liens: A Practical Overview*, 6 Bridgeport L. Rev. 77, 82 (1985) (briefly describing the two hundred year history of attorneys' liens in England and in the colonial United States).

A charging lien differs from an attorney's retaining lien because it does not depend upon possession. R. Rossi, *Attorney Fees*, §12:13 at p.12-22 (West 3rd Ed. 2001) (hereafter "Rossi"). "An attorney's charging lien, it has been said, is a peculiar lien, and is not like any other lien known to the law." *Id.* The term "lien" is somewhat of a misnomer with respect to attorneys' liens because a true lien at common law required possession of another's property, but an attorney's charging lien, on the other hand:

> "is the equitable right of an attorney to have his fees and charges for costs advanced for services in a particular suit, secured by the judgment or recovery in the suit or action in which the attorney's services were rendered. It is based upon equitable considerations and differs from ordinary liens in that possession is not essential."

Crawford v. Crane, 204 Or. 60, 62, 282 P.2d 348, 349 (Or. 1955).

Rossi, clearly the leading treatise, has noted that the charging lien was created under the common law "for the protection of attorneys against the knavery of their clients," and " . . . is upheld on the theory that the attorney's services and skill produced the judgment . . . " Rossi at §12:13 at p.12-23. "If the attorney's work produces no fruit, the attorney has no lien." *Id.* at §12:27 at p.12-43.

Liens and assignments are two different animals. As the Oregon Supreme Court noted in *Potter v. Schlesser,* "[a]ccording to its dictionary definition, a 'lien' denotes a

'charge upon real or personal property for the satisfaction of some debt or duty ordinarily arising by operation of law' or 'a right in one to control or to hold and retain or enforce a charge against the property of another until some claim of the former is paid or satisfied[.]'" *Webster's Third New Int'l. Dictionary* 1306 (Unabridged Ed. 1993). An "assignment," on the other hand, is "a transfer or making over to another of the whole of any property . . . " *Black's Law Dictionary*, p.1097 (5th Ed. 1979). An attorney who represents a client in litigation, and whose labors results in a judgment, does not receive a "transfer" of the client's interest in the judgment; she creates the client's judgment from the fruit of her own labor.

In 1862 Oregon enacted the Deady Code, which replaced the common law with respect to the nature and extent of an attorney's charging lien. *Day v. Larsen*, *supra*. The Code provided that "an attorney has a lien for his compensation, whether specially agreed upon or implied, . . . upon a judgment or decree, to the extent of the costs included therein, or if there be a special agreement, to the extent of the compensation specially agreed upon . . . " M.Deady & L.Lane, General Laws of Oregon 1843-1872, §1012 (1874) (enacted 10/11/1862). In the presence of a statute creating the lien "upon the cause of action," the lien attaches "to the proceeds of a judgment obtained by the attorney, and in some circumstances to the proceeds of a settlement," and only *in the absence of a statute* does a charging lien operate as an equitable assignment. *Rossi* at §12:27 at p.12-43-44.

In 1939, Oregon revised its attorney's lien statutes based upon Georgia law, and in 1975 made its most recent revisions to Oregon law. *See Ohle, W., Oregon's Attorneys' Liens*, 27 Will.L.Rev. 89, 893 (1991). In 1975 Oregon Laws

chapter 648, the legislature rewrote Oregon's laws regarding all forms of liens, including possessory and non-possessory chattel liens, liens on real property, *and* attorney's liens. These provisions are now found in ORS 87.142 to 87.490. The 1975 amendments repealed ORS 87.495, which provided for charging liens by attorneys without specifying a specific remedy. The provisions of *former* ORS 87.495 are now set forth virtually *verbatim* in ORS 87.445, 87.480, and 87.430. Oregon law presently provides that an attorney obtains a charging lien in one of three ways:

First, an attorney obtains a charging lien upon the action by statute under ORS 87.455[2] when she "commences" an action, suit or proceeding on behalf of her client. Second, the charging lien extends to and is upon the judgments, orders and awards "entered therein" in favor of her client pursuant to ORS 87.445. Third, an attorney obtains a charging lien upon any "settlement between the parties" before or after judgment by virtue of ORS 87.475(1).[3]

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[2] ORS 87.445 provides: "An attorney has a lien upon actions, suits and proceedings after the commencement thereof, and judgments, decrees, orders and awards entered therein in the client's favor and the proceeds thereof to the extent of fees and compensation specially agreed upon with the client, or if there is no agreement, for the reasonable value of the services of the attorney."

[3] ORS 87.475 provides:

> (1) Except as provided in subsections (3) and (4) of this section, the lien created by ORS 87.445 is not affected by a settlement between the parties to the action, suit or proceeding before or after judgment, decree, order or award.
>
> (2) Except as provided in subsections (3) and (4) of this section, a party to the action, suit or proceeding, or any other person, does not have the right to satisfy the lien created by ORS 87.445 or any judgment, decree, order or award

(Continued on following page)

The lien extends to the "fees and compensation specifically agreed upon with the client, or if there is no agreement, for the reasonable value of the services of the attorney." ORS 87.445; *See Rossi* §12:15-12:16.

Although Oregon attorneys "have the same right and power over actions, suits, proceedings, judgments, orders, and awards, to enforce their liens as their clients have for the amount due to them," until *Potter v. Schlesser, supra,* the Oregon Supreme Court struggled with the manner of enforcement of a charging lien. Indeed, until *Potter,* Oregon courts had never affirmed any method for enforcement of an attorneys' charging lien.

In *Jackson v. Stearns,* 48 Or. 25, 29, 84 Pac. 798, 800 (Or. 1906), the court suggested that Oregon law allowed an attorney to continue the cause of action over her client's objection, if the attorney could show that the parties in the litigation had intentionally settled the case to defraud the attorney of her fees.

An attorney whose lien has attached may apply to the court to set aside any disposition of the litigation or settlement, such as setting aside any satisfaction given by

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entered in the action, suit or proceeding until the lien, and claim of the attorney for fees based thereon, is satisfied in full.

(3) A judgment debtor may pay the full amount of a judgment or decree into court and the clerk of the court shall thereupon fully satisfy the judgment or decree on the record and the judgment debtor shall be thereby released from any further claims thereunder.

(4) If more than one attorney appears of record for a litigant, the satisfaction of the lien created by ORS 87.445 by any one of the attorneys is conclusive evidence that the lien is fully satisfied.

the client or reinstating any judgment of dismissal. *Rossi* §12:35. This remedy – continuation of the client's action – has survived since the common law and has been known since the times of Lord Mansfield, but "is not particularly favored by the courts." *Rossi* §12:36 at p.12-55.

Twenty-seven years later, Oregon held that an attorney employed on a contingent fee basis who lost at a trial could not pursue an appeal over her client's objections. *In re Grimes,* 170 Or. 204, 131 P.2d 448 (Or. 1943). *See Rossi* §12:39.

In *Adams v. Transamerica Insurance Group,* 45 Or. App. 769, 609 P.2d 834 (Or. 1980) the Oregon Court of Appeals held that an attorney lacked standing to take action in conflict with the wishes of a former client to overturn a workers compensation award, which set aside a settlement, that would have provided for the attorney's fee. Subsequently the Oregon Supreme Court held that Adams' effort to enforce his attorney's lien violated a Disciplinary Rule of the court that prohibited an attorney from intentionally prejudicing or damaging the client during the course of the professional relationship. *In re Conduct of Adams,* 293 Or. 727, 652 P.2d 787 (Or. 1982). Thus, continuation of the litigation, while permitted at law as a remedy for payment of an attorney's lien, carried with it the risk of disbarment or suspension unless the attorney sought to enforce the lien after termination of the professional relationship. "Under certain circumstances, an attorney's assertion of a lien may constitute a violation of an ethical code or rules governing professional conduct." *Rossi* §12:2 at p.12-5.

In *Crawford v. Crane*, 204 Or. 60, 65, 282 P.2d 348 (Or. 1955), the Oregon Supreme Court held that a summary proceeding for foreclosure was not the proper method for

resolution of an attorney's charging lien.[4] *Crawford, in dicta*, commented that:

> Generally speaking, in the absence of statutory direction there is no well-settled method for the enforcement of either a retaining lien or a charging lien. The methods for the enforcement of each kind are different and for each vary in different jurisdictions. [citing CJS] *** No statutory method has been provided in this state for the enforcement of a charging lien, as such. ***

[4] At the time of the *Crawford* decision, §67-1601 OCLA provided in relevant part:

> "An attorney has a lien for his compensation, whether specially agreed upon or implied, as provided in this section: . . . (2) Upon actions, suits and proceedings after the commencement thereof, and judgments, decrees, orders and awards entered therein in his client's favor and the proceeds thereof in whatsoever hands they may be or come to the extent of the fees and compensation specially agreed upon with his client, . . . and *such lien shall not be affected by any settlement between the parties to the action, suit or proceeding before* or after *judgment*, decree, order or award." (Emphasis added)

Although the legislature has since fundamentally amended the statute, the operative language is still virtually identical. ORS 87.445 provides:

> "*An attorney has a lien upon actions*, suits and proceedings *after the commencement thereof*, and judgments, decrees, orders and awards entered therein in the client's favor *and the proceeds thereof* to the extent of fees and compensation specially agreed upon with the client. . . ." (Emphasis added)

ORS 87.475 provides:

> "Except as provided in subsections (3) and (4) of this section, *the lien created by ORS 87.445 is not affected by a settlement between the parties to the action, suit or proceeding before or after judgment decree, order or award. Subsections (3) and (4) are irrelevant to this case.*" (Emphasis added)

> The provisions of these two sections [*former* OCLA 47-516 & 47-517; *currently* ORS 9.360 & 9.370] provide the only statutory method for securing judicial attention and subsequent enforcement of a retention lien claimed under §67-1601, O.C.L.A. However, they do not supply a remedy or method for the enforcement of an attorney's charging lien, the character of the Hughes lien.
>
> We do not here undertake to say what methods are available to appellant for the enforcement of his charging lien, nor do the exigencies of this appeal demand that we do so. The kinds of relief that might be available, as we have earlier indicated, are not settled but are various and are apparently, in the absence of statutory direction, controlled by peculiar circumstances attending the character of the lien asserted, that is, for example, whether the amount claimed is fixed and determined, unliquidated or contingent, or whether the claim rests upon asserted reasonable value in the absence of an express agreement for compensation. *** [citing CJS] regarding enforcement of a charging lien.

Crawford recognized that equity would enforce the attorney's charging lien depending on the circumstances of each case. The fact that enforcement of a charging lien is "equitable in nature" is in keeping with the "peculiar" nature of this lien. *Rossi* §12:33. *Crawford*, however, did not decide the specific procedure that equity would use, but instead noted that a "suit to foreclosure a lien created by ORS 87.445," was limited only to liens against personal or real property. Indeed, *Crawford* limited its *dicta* to a *retaining* lien, not to a charging lien under ORS 87.445.

Crawford relied on the general principles set forth in *Corpus Juris Secundum*, which stated:

> "Generally speaking, in the absence of statutory direction, there is no well settled method for enforcement, and the manner of enforcement varies in different jurisdictions. * * * The remedy for enforcing the lien may be left to the court, and it is for the court to determine whether the method selected by the attorney is appropriate under all the facts and circumstances." 7A C.J.S. *Attorney & Client* §391.

Concluding that the court below had erroneously relied on the summary procedures for a possessory lien, the Oregon Supreme Court reversed and dismissed the proceeding without prejudice "to such action as either party deems appropriate in the premises." *Crawford*, 282 P.2d at 351-52.

With that background in mind, in *Potter v. Schlesser, supra,* the Oregon Supreme Court held that an attorney may bring a direct action against a defendant who settles with his client without satisfaction of the attorney's lien.

In *Potter*, a client hired an attorney on a contingent fee basis, and thereafter settled directly with the opposing party. The attorney could always have sued his client for breach of the contingent fee agreement and, thereafter, sought to obtain a judgment against his client and then execute upon client assets. The Oregon Court of Appeals, however, first erroneously held that the attorney's lien statutes were "intended to create a *statutory enforcement mechanism* in situations where parties settled an action without discharging an attorney's lien," and rejected the attorney's argument that he had a statutory remedy under ORS 87.445. *Potter v. Schlesser,* 171 Or. App. 646, 655, 17

P.3d 529, 534 (Or.App. 2000). The intermediate court reached its result contrary to the majority rule described in *Rossi* at §12:40.

When *Potter* reached the Oregon Supreme Court, however, it reversed and articulated for the first time in its history, the manner for enforcement of an attorney's charging lien in Oregon when a client breached a contingent fee agreement. It held that the attorney's charging lien provided the lawyer with a direct property interest in his client's litigation, which was impaired when the client and the opposing party directly settled the dispute without satisfaction of the attorney's charging lien "upon the client's action." The court, thus, held that the attorney was entitled to sue the client's former opponent for enforcement of the lien. Indeed, even after the action had been dismissed and compromised directly by the client and the opposing party, and after the proceeds of the settlement had been disbursed to the client, the attorney retained a property interest "in the action," which the opposing party was required to satisfy.

Had the Oregon Supreme Court viewed an attorney's lien as a mere assignment of client income, as opposed to a direct property interest of the attorney, then attorney Potter could not have proceeded directly against the party who had settled directly with Potter's former client. The settling party paid twice. Had an attorney's lien been premised upon a mere assignment, this party would have successfully asserted that the settlement with the attorney's former client released it from liability to the attorney. Because Potter had a direct property interest in the action, judgment and settlement, his remedy was to proceed against the party who was released from liability by the former client.

The decision in *Potter* was not an aberration or departure from the well settled principles of law or the decision of other courts. For, example, it is hornbook law that:

> "After an attorney's lien has attached, the party adverse to his client, with notice of the lien, cannot destroy it by a voluntary settlement of the claim, without the consent or knowledge of the attorney, without becoming personally liable for the value of the lien. As had been said, a party paying a judgment, or the amount of a compromise, knowing it to be charged with an attorney's lien, is bound to retain, and the law conclusively assumes he has retained, a sufficient amount to pay the lien." *Rossi*, at §12:40, p. 12-65.

> "[A] defendant who settles with plaintiff without knowledge or consent of plaintiff's attorney does so at his own risk as to the attorney's lien, especially where a cause of action actually existed between the parties to the cause and there was notice of the attorney's lien." 7A C.J.S. *Attorney & Client* §386.

> "He may, likewise, in a proper case, enforce the lien against an associate attorney, or against defendant in the litigation in which professional services were rendered as the basis of the lien. * * * The lien may also be enforced against persons who have received the proceeds of a judgment or settlement without due regard for the pending lien." 7A C.J.S. *Attorney & Client* §391(b).

In *Northern Pueblo Enterprises v. Montgomery*, 644 P.2d 1036, 1038 (N.M. 1982), the New Mexico Supreme Court remanded for further equitable proceedings to enforce a charging lien:

> " . . . which is defined as an attorney's right 'to recover his fees and money expended on behalf of his client from a fund created by his efforts, and also the right to have the court interfere to prevent payment by the judgment debtor to the creditor in fraud of his right to the same, and also to prevent or set aside assignments or settlements made in fraud of his right.' *Prichard v. Fulmer*, 22 N.M. 134, 140, 159 P. 39, 41 (1916)."

See also Cherpelis v. Cherpelis, 959 P.2d 973, 976 (N.M. App. 1998) (court enforces attorney's charging lien, citing *Prichard*, *supra*, and noting that "a court of equity has power to meet the problem presented, and to fashion a proper remedy that will meet the result.")

In *Munro v. Munro*, 424 N.W. 2d 16 (Mich. App. 1988), the court enforced an attorney's charging lien against his client's successor attorney, finding that successor attorney knew or should have known of plaintiff's lien:

> "An attorney's lien is not enforceable against a third party unless the third party has actual notice of the lien or unless circumstances known to the third party are such that he should have inquired as to the claim of the attorney."

Id. at 17-18. The successor attorney's remedy "was to withhold that portion of the proceeds which were necessary to satisfy the lien, and thereafter turn over the remaining amount to his client." *Id.* at 18. The court also expressly rejected the successor attorney's argument that the Code of Professional Responsibility created an ethical obligation that required him to turn over the disputed settlement funds to his client, rather than withhold them or interplead them into court pending resolution of the attorney's lien dispute.

In the Matter of Estate of Gutchess, 456 N.Y.S. 249 (A.D. 1982), the New York Supreme Court affirmed a trial court's stay of the distribution of the assets of an estate pending resolution of the former attorney's lien claim, where parties had settled estate litigation with assistance of successor counsel. The lien attached to the claim from the "commencement of an action" and attached to the settlement proceeds even though the matter settled without a final determination of the dispute by the Surrogate's Court. "The fact that the representatives of the two estates reached a settlement does not affect petitioner's lien." *Id.* at 251. The Court affirmed the lower court's stay order by requiring that an amount sufficient to satisfy the attorney's fee lien be withheld from the balance of the estate.

See also *In re De Berry*, 59 B.R. 891 (E.D. N.Y. 1986), (bankruptcy court protects funds distributed to plaintiff's attorney's after settlement of a personal injury claim on behalf of the debtor against claim by trustee. The Court noted that, by statute, the attorney's lien attached "from the commencement of the action" and that "the lien attaches to the proceeds of a settlement the same as it would attach to a judgment.")

In Utah, the court allowed an equitable suit to be filed against both the ex-client and opposing party, but required plaintiff to try to first collect from his ex-client. In *Eastmond v. Earl*, 912 P.2d 994 (Utah 1996), plaintiff's attorney brought his claims for fees against both his former client and her ex-husband to recover on his charging lien. The Utah Court of Appeals affirmed the trial court's summary judgment in favor of the attorney's charging lien against the ex-husband, who had elected to pay sums to the attorney's client despite notice of the attorney's lien.

Although the court noted that the attorney ordinarily must first try to collect from the party receiving the proceeds, in *Eastmond*, the attorney's client had been discharged in bankruptcy during the pendency of the action. *See* also *Lundy v. Cappuccio*, 181 P. 165 (Utah 1919) (Utah Supreme Court remands with instructions that attorneys claiming lien bring proceedings against all potentially liable parties, including garnishers, where debtor paid third party garnishment instead of attorneys' lien on judgment, with enforcement against debtor contingent on inability to collect lien from garnishers).

The nature of an attorney's charging lien differs from other "liens;" it is an equitable right created by the court to protect attorneys and has always provided an attorney with a direct property interest "in the action," to protect the "fruits of the attorney's skill and labor," and directly is a property interest in his or her client's litigation; it is a direct "charge upon the action," and, as such is not a mere "assignment" of client income from the litigation.

2. Written Notice Is Not Required To Perfect A Charging Lien.

Contrary to the Commissioner's brief at page 39, there is no requirement that an attorney perfect the lien by filing written notice. However, the property interest of an attorney, as created by Oregon's lien statutes, may be lost after a specified period of time.

The lien exists so long as the attorney is counsel of record in her client's litigation, and continues for a specified period of time after judgment without any written notice. The charging lien provides all of the protection necessary for an attorney, and the mere fact that a client is

represented by counsel in pending litigation is notice to the world of the existence of the attorney's charging lien.

Filing suit is sufficient notice, and indeed is actual notice of the attorney's lien upon the action. *Rossi* at §12:19 p.12-31. However, in Oregon an attorney will lose her lien unless within a specific period of time after entry of a judgment "for a sum of money" (three years) or judgment for "the possession, award," transfer or conveyance of real property (six months) and personal property (one year), written notice is filed with the clerk of the court or county recorder. ORS 87.465, ORS 87.450(1),[5] 87.455, 87.460.

Moreover, written notice of the lien is prudent practice when an attorney is discharged, or the client changes counsel, because at that juncture, the attorney loses control over the action, ORS 87.480, and the client's new counsel gains the ability to satisfy the discharged attorney's lien, ORS 87.475(4). The reason for written notice of the existence of a direct property interest by a discharged attorney in her client's litigation is readily apparent. An

[5] (1) When an attorney claims a lien under ORS 87.445, if the judgment or decree is for a sum of money only, the attorney must file a notice of claim of lien with the clerk of the court that issues the judgment or decree within three years after the judgment or decree is given. The clerk shall enter the notice in the records of the action or suit and shall also make a note of the filing of the notice in the judgment docket of the court.

(2) When an attorney files a notice of claim of lien under subsection (1) of this section, the attorney shall send forthwith a copy of the notice to the client by registered or certified mail sent to the client at the last-known address of the client.

(3) A lien under ORS 87.445 on a judgment or decree for a sum of money only remains a lien on that judgment or decree for as long as the judgment or decree remains valid under ORS 18.360 or 18.365.

attorney, like any other party to a contract, has always been able to sue a client who breaches a contract to pay fees. However, after an attorney is discharged, she has lost "the same right and power over actions, suits, proceedings, judgments, decrees, order, and awards to enforce their liens as their clients have." The Commissioner's reliance upon the written notice provisions of Oregon law, thus, do not support the argument that attorney's lack a proprietary interest in their client's litigation.

B. The Nature of a Contingent Fee Agreement in Oregon.

Even when an attorney's lien "upon the action" has not yet attached, such as when an action has not been filed, or when a potential claim is settled before commencement of any suit, action or proceeding, a contingent fee agreement creates an "equitable lien" in the action which, as a practical matter, is identical to an attorney's lien. Some courts have held that "a contract for a contingent fee is deemed to create a *pro tanto* equitable assignment, or to transfer an equitable interest in favor of the attorney in the cause of action or in the proceeds thereof." *Rossi* §2:4 at p.2-10. *Rossi* also notes that the distinction between the contract right of an attorney in contingent fee litigation creating an "assignment," and an attorney's lien created by statute, is "somewhat artificial" and "may turn on semantic differences that do not necessarily correspond to the intentions of the parties."

> "Many jurisdictions have enacted attorneys' fee lien statutes. While the lien statute may provide the only method of obtaining such a lien in some jurisdictions, and the practical value of obtaining an equitable lien has been diminished in other

> jurisdictions because of the statutory remedy, equitable lien principles can often be utilized despite the existence of a lien statute." *Id.* at p.2-13.

The existence of a contingent fee, whether before or after the commencement of litigation, also provides another source for an attorney's direct proprietary interest in her client's litigation.

In Oregon as in many States, an attorney may enter into a contingent fee agreement for compensation in certain cases. As such, an attorney acquires a "proprietary" interest in the client's litigation in Oregon. Disciplinary Rule DR 5-103(A)(2) provides that "[a] lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting, except that the lawyer may: * * * [c]ontract with a client for a reasonable contingent fee in a civil case, subject to the limitations imposed by DR 2-106."

The term "proprietary" has a plain and unambiguous meaning. It means "[b]elonging to ownership; belonging or pertaining to a proprietor, relating to a certain owner or proprietor; made and marketed by a person or persons having the exclusive right to manufacture and sell such; as proprietary article, medicine or food," and "proprietor" means "one who has the exclusive title to a thing; one who possesses or holds the title to a thing in his own right; one who possesses the dominion or ownership of a thing in his own right." *Black's Law Dictionary*, p.1097 (5th Ed. 1979).

At common law, contingent fee agreements were considered champertous, and therefore, illegal. *Rossi* §2:1 at p.204. "Champerty is the intermeddling of a stranger in the litigation of another, for profit, and maintenance is the

financing of such intermeddling." *Groce v. Fidelity General Ins. Co.*, 252 Or. 296, 304-305, 448 P.2d 554, 558 (Or. 1968). In Oregon, champerty resulted when an attorney was "buying up doubtful claims," but an attorney hired on a contingent fee basis did not, strictly speaking, engage in champerty because she did not prosecute litigation in her own name. *See Craig v. Maher,* 158 Or. 40, 47, 74 P.2d 396, 399 (Or. 1937).

Oregon's disciplinary rules concerning contingent fees are substantially similar to Rule 1.8(j) of the Rules of Professional Conduct of the American Bar Association, which provides:

> A lawyer shall not acquire a proprietary interest in the cause of action or subject matter of litigation the lawyer is conducting for the client, except that the lawyer may: (1) acquire a lien granted by law to secure the lawyer's fee or expenses. . . .

It is often said that a contingent fee is the "poor man's key to the courthouse door," and is often the only way that the middle class can have their rights vindicated by enabling one with a meritorious cause of action to obtain competent counsel. *See Rossi* §2:3 at p.2-8 fn.1. For most Americans, the contingent fee offered by plaintiff's counsel plays an absolutely essential role in the administration of justice. The Commissioner's misinterpretation of "income" of the taxpayer, as including the attorney fees paid to an attorney under a contingent fee agreement, simply shuts the courthouse doors and excludes individuals in the middle class and the poor from equal access to justice by manipulation of the tax code.

Contingent fee agreements between attorney and client are subject to legislative limits, however. For example in Oregon, contingent fees are prohibited in criminal cases or domestic relations cases. *See* DR 2-106(C). In civil personal injury cases, special protection is provided to clients in order to render enforceable a contingent fee agreement, including plain language requirements, a "model" explanation and a 24-hour rescission period. ORS 20.340. While personal injury judgments and settlements are excluded from an individual's gross income under IRC §104(a)(2), contingent fees agreements are frequently used by plaintiff's attorneys bringing cases to vindicate employee rights under Oregon common law and discrimination statutes, consumer rights cases, cases for economic injury for homeowners, insureds and investors brought under hundreds of state statutory fee-shifting statutes[6],

[6] A few notable examples of fee-shifting statutes in Oregon include:

- *Wage Claims.* Failure to pay wages or overtime. ORS 652.200. Unequal pay. ORS 652.230.
- *Consumer Protection Statutes.* Consumer entitled to recovery the greater of actual damages or $200, plus attorney fees for unlawful trade practices. ORS 646.638. Unlawful debt collection practices. ORS 646.642. Warranty claims under $2,500. ORS 20.098.
- *Securities Violations.* Purchaser of securities may recover consideration paid for security, plus attorney fees. ORS 59.115(10).
- *Insurance Claims.* Insurance policyholder entitled to recovery of attorney fees against insurer when recovery exceeds amount tendered by insurer in action upon any policy of insurance. ORS 742.061(1).
- *Contract Claims.* In all contract claims, when amount due is less than $5,500, reasonable attorney fees are paid to prevailing party. ORS 20.082. Actions on dishonored checks. ORS 30.701(3).
- *Property Claims.* In all property damage claims, when the amount pled is less than $5,500, attorney fees are paid to prevailing party. ORS 20.080. Trespass or nuisance arising from farming or forest practices. ORS 30.938. Condemnation proceedings. ORS 20.085.

(Continued on following page)

contract claims providing for the prevailing party to recover attorney fees,[7] and in split-recovery cases,[8] such as punitive damage claims, where litigants act as private attorneys general for the financial benefit of the State of Oregon.

In each of these areas, the Oregon Legislature made a decision to provide attorney fees to a prevailing plaintiff is designed to "make whole" a party in litigation. Attorneys representing plaintiffs in fee shifting cases routinely represent the plaintiff on the basis that the court's award of attorney fees will be credited against the contingent fee recovery so that the attorney receives the greater of either the percentage agreed upon in the fee agreement or the court ordered amount of attorney fees. *Chalmers v. Oregon Auto. Ins. Co.*, 263 Or. 449, 454, 502 P.2d 1378, 1381 (Or. 1972).

- *Discrimination Claims.* Discrimination in employment, public accommodation, real property transactions. ORS 659A.885(5)(d); ORS 20.107.

[7] Many but not all of the fee-shifting statutes cited above are reciprocal, and provide attorney fees for the prevailing party. Oregon law also provides that in all contracts that provide attorney fees for enforcement of the contract, the party that prevails on the claim, whether specified in the contract or not, is entitled to reasonable attorney fees. ORS 20.096.

[8] Oregon limits distribution of punitive damages under a "split-recovery" statute under which the Department of Justice of the State of Oregon is paid 60% of all verdicts for punitive damages, ORS 31.735(1)(b) (*former* 18.540(1)(b)). The prevailing party entitled to receive punitive damages is limited to 40%, and the party's attorney "shall be paid out of the amount allocated under this paragraph . . . in no event may more than 20 percent of the amount awarded as punitive damages be paid to the attorney for the prevailing party." ORS 31.735(1)(a) (*formerly* 18.540(1)(a)). *See DeMendoza v. Huffman*, 334 Or. 425, 51 P.3d 1232 (2002).

The Commissioner's proposed rule would have a profound impact upon this "make whole" remedy. The simplest example arises in consumer cases or small wage cases where the plaintiff's taxable compensatory or statutory damages are small. For example, the jury may award, $200, in an Unlawful Trade Practices Act claim, and the court may thereafter award $100,000 to the plaintiff for the recovery of attorney fees. The Commissioner's rule would include the gross recovery, $100,200, in the gross income to the individual taxpayer. Although the taxpayer would pay $100,000 in attorney fees, he or she would also owe AMT $26,000, notwithstanding a compensatory damage award of $200. Thus, the taxpayer would pay $26,000 in AMT for the "privilege" of vindicating the right to receive $200. This absurd result is the direct consequence of the Commissioner's incorrect interpretation of the property interest of attorneys in a contingent fee case, and would destroy the "make whole" remedy, not because of the intended tax impact on the $200 in compensatory damages, but because of the unintended tax impact upon the award of attorney fees.

When the above example is applied to reciprocal attorney fees, the bizarre consequences of the Commissioner's position becomes more stark. A jury may render a verdict against a plaintiff and in favor of an individual defendant who thereafter receives an award of $100,000 in attorney fees from the court. The Commissioner would include the $100,000 awarded to the prevailing defendant in the defendant's gross income. The defendant would thereafter owe $26,000 in AMT for the "privilege" of successfully defending the lawsuit. The defendant is, thus, never, "made whole."

Under a split recovery statute, inclusion of attorney fees in the income of the taxpayer can be even more dramatic. Contrary to its position in *Banaitis,* the Commissioner has determined that a taxpayer is not required to include in gross income the portion of a punitive damage recovery that is rendered to the state pursuant to a split recovery statute. *IRS Chief Counsel Advice C.C.A. #200246003* (The non-binding effect of the C.C.A. on the Commissioner is expressly noted therein and cautions that "it should not be cited as precedent"). The C.C.A. did not permit a deduction for the 60% paid to the State; it determined that this portion of a punitive damage recovery was not included in gross income because the taxpayer "did not have command over the disposition of the portion of the proceeds deemed rendered to the state." However, there is little reason to distinguish between the 60% paid to the State and the 20% paid to the taxpayer's attorney under the split recovery statute. The taxpayer has no more or less a "command" over the disposition of the State's share as he or she does over the attorney's share of a punitive damage recovery. However, a taxpayer, under the Commissioner's proposed rule in this Court, due to its "assignment of income" rationale, would be required to include the State's 60% share in his or her gross income.

The proprietary interest of an attorney in their client's litigation as a result of a contingent fee is a matter wholly within the sovereign authority of the States and, more importantly is central to each State's judicial branch of government. Indeed, this Court has held that "the regulation of the activities of the bar is at the core of the State's power to protect the public." *Bates v. State Bar of Arizona,* 433 U.S. 350, 361, 97 S.Ct. 2691, 2697, 53 L.Ed.2d 810 (1977). *Goldfarb v. Virginia State Bar,* 421 U.S. 773, 792,

95 S.Ct. 2004, 2016, 44 L.Ed.2d 572 (1975) ("The interest of the States in regulating lawyers is especially great since lawyers are essential to the primary governmental function of administering justice, and have historically been 'officers of the courts'.") A State Supreme Court's sovereign authority to define the interests of an attorney in a client's litigation is at "the core of the State's power to protect the public" because few other professions are "essential to the primary governmental function of administering justice." *See In re Griffiths,* 413 U.S. 717, 722-23, 93 S.Ct. 2851, 2855, 37 L.Ed.2d 910 (1973).

The Disciplinary Rules of Oregon are matters entirely within the authority of the Chief Justice of the Oregon Supreme Court as the administrative head of the judicial department. ORS 1.002(1). The Oregon Supreme Court has adopted ethical codes to permit an attorney to gain a proprietary interest in a client's civil action under a reasonable contingent fee agreement. This evidences a compelling state interest concerning the property rights of litigants. That the Oregon legislature has permitted an attorney to obtain a lien "upon the action" of a client, evidences "the legislature's limitation . . . on the court's disciplinary authority . . . [over attorneys]." *In re Conduct of Allen*, 326 Or. 107, 118, 949 P.2d 710 (1997); *Ramstead v. Morgan,* 219 Or. 383, 399, 347 P.2d 594 (1959) (held: the Legislature "may act authoritatively with respect to some matters which affect the judicial process.").

That the Oregon Supreme Court has determined that an attorney may acquire a proprietary interest in her client's litigation only by a reasonable contingent fee in certain civil litigation, is further evidence that Oregon, like many other states, has created an unique ownership interest for attorneys in their client's litigation to protect

the individual's access to justice. The state has a compelling interest in providing attorneys with a proprietary interest in contingent fee litigation that is subject to an attorney's lien.

The Commissioner criticizes the Ninth Circuit for reaching different results within its Circuit, but the court was bound to determine property interests in accordance with the law of the State in which the income was earned.

Of course, the "assignment" of income doctrine, first applied in *Lucas v. Earl,* 281 U.S. 111, 114-15 (1930), was never designed to tax the same income twice, but instead was designed to prevent the shifting of income, often to related parties, family members in lower brackets. In each of these cases, unlike contingent attorney fees, the taxpayer had earned and created the right to receive and enjoy the benefit of the income prior to its assignment. Although some states may follow the "anticipatory assignment of income" doctrine with respect to the property interest of an attorney in a client's recovery, it is apparent that Oregon does not. In the present case, the attorney pays tax on the share of attorney fees earned at the attorney's taxable rate, and the client pays tax on the client's share of the judgment or settlement at the individual taxpayer's rate. The design is not to "shift income," but rather, it is to tax the income of the person who earned it, and not to tax income where it is not created.

Banks v. Commissioner, 345 F.3d 1074 (9th Cir. 2003) provides the most consistent and rational treatment for contingency attorney fees by holding that such fees are not an "assignment of income," and are excludable from gross income by joining in the Fifth Circuit in *Srivastava v. Commissioner,* 220 F.3d 353, 364 (5th Cir. 2000), the Sixth

Circuit in *Estate of Clarks v. United States,* 202 F.3d 854 (6th Cir. 2000) and Eleventh Circuit in *Foster v. United States,* 249 F.3d 1275 (11th Cir. 2001). These cases hold simply that contingent attorney fees are excludable from gross income of the taxpayer. They reach the correct result, and for slightly different reasons than the Ninth Circuit in *Banaitis*, which was reached based upon a state attorney lien law analysis to identify property ownership in litigation. Also *see Cotnam v. Commissioner,* 263 F.2d 119 (5th Cir. 1959). However, if the Court rejects the *Banks* rationale, it cannot thereafter ignore the rationale of *Banaitis* and *Cotnam* that under state law, attorneys have an ownership interest in their client's litigation by virtue of a contingent fee entered into in accordance with the Oregon Supreme Court's Disciplinary Rules, and in litigation subject to the Oregon Legislature's attorney lien statutes.

IV. CONCLUSION.

For each of the reasons set forth above, this Court must recognize the particular proprietary interest that an attorney has in a client's litigation under a contingent fee that is subject to an attorney's lien. The attorney's fees earned by the attorney are the attorney's income; not the client's tax nightmare.

Respectfully submitted,

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In The
Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

JOHN W. BANKS, II,

Respondent.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

SIGITAS J. BANAITIS,

Respondent.

On Writ Of Certiorari
To The United States Court Of Appeals
For The Sixth And Ninth Circuits

BRIEF FOR *AMICI CURIAE* PROFESSOR GREGG D. POLSKY AND PROFESSOR BRANT J. HELLWIG IN SUPPORT OF PETITIONER

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QUESTION PRESENTED

This brief for *amici curiae* will address the following question presented in the petition for a writ of certiorari:

Whether, under Section 61(a) of the Internal Revenue Code, 26 U.S.C. § 61(a), a taxpayer's gross income from the proceeds of litigation includes the portion of his damages recovery that is paid to his attorneys pursuant to a contingent fee agreement.

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INTEREST OF THE *AMICI CURIAE*

Amici curiae are teachers and scholars of the tax law. The issue in these cases involves a subject in which they have a special academic interest and about which they have written. Except for their academic interest, *amici* have no interest in the outcome of these cases.[1]

SUMMARY OF ARGUMENT

Various Circuit Courts of Appeal have reached opposing conclusions on the issue of whether a plaintiff must include in gross income the portion of a recovery that is paid to her attorney pursuant to a contingency fee agreement. The root of the disagreement between those courts holding that the plaintiff's gross income includes the entire recovery and those holding that the plaintiff's gross income is limited to the net recovery that remains after payment of the attorney's fee is the characterization of the contingency fee arrangement.

The courts that have concluded that the contingent attorney's fee is excluded from the plaintiff's gross income view the plaintiff as having transferred, for federal tax purposes, a portion of the underlying cause of action to the

[1] Pursuant to this Court's Rule 37.3(a), letters of consent from all parties to the filing of this brief have been filed with the Clerk. Pursuant to this Court's Rule 37.6, *amici* state that this brief was not authored in whole or in part by counsel for any party. *Amici* received no monetary contribution for the preparation or submission of this brief apart from the financial support of their respective academic institutions to defray the costs of printing the brief. The opinions expressed in this brief are those of the individual *amici*, and do not necessarily reflect the views of the institutions at which they teach.

attorney upon the execution of the fee agreement. In this manner, the plaintiff and attorney emerge from the agreement as co-owners of the claim. The courts concluding that the plaintiff must include the entire recovery in gross income (including the portion paid to the attorney as a contingent fee) treat the plaintiff as the sole owner of the claim at all times. As it turns out, the characterization of the contingency fee arrangement is of no particular moment. If the tax laws are properly applied, the resulting tax consequences are the same under either description. Regardless of the characterization of the contingent fee arrangement, the plaintiff must include the entire amount of the recovery in gross income, and any portion of the recovery paid to the attorney as a contingency fee gives rise to a deduction.

The courts that have allowed the plaintiff to exclude the attorney fee portion of the recovery failed to apply the tax law correctly. If, in fact, the plaintiff is properly viewed as having transferred a portion of the underlying cause of action to the attorney upon execution of the contingent fee agreement, the transfer of that portion of the claim carries its own tax consequences. In particular, because the transfer of the portion of the claim to the attorney is made in connection with the provision of services by the attorney, the tax consequences of the transfer are governed by § 83 of the Internal Revenue Code. Had these courts properly applied § 83, they would have concluded that the plaintiff's gross income includes the entire recovery–including the portion of the claim proceeds paid to the attorney under the contingency fee agreement. Rather than being excluded from the plaintiff's gross income, the

amounts paid to the attorney as a contingent fee would have given rise to a deduction.

ARGUMENT

The Circuit Courts of Appeals are split on the issue of whether a plaintiff who hires an attorney to prosecute a cause of action for taxable damages on a contingency basis must include in gross income the portion of the recovery paid to the attorney. A majority of circuits to address the issue have concluded that the entire recovery is included in the plaintiff's gross income, leaving the plaintiff with a deduction for the amount of the attorney's contingent fee. *See Raymond v. United States*, 355 F.3d 107 (2d Cir. 2004); *Campbell v. Commissioner*, 274 F.3d 1312 (10th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3d 881 (7th Cir. 2001); *Young v. Commissioner*, 240 F.3d 369 (4th Cir. 2001); *Baylin v. United States*, 43 F.3d 1451 (Fed. Cir. 1995); *O'Brien v. Commissioner*, 319 F.2d 532 (3d Cir. 1963). On the other hand, a minority of circuits have held that the plaintiff's gross income includes only the net amount retained by the plaintiff; that is, the total recovery reduced by the contingent fee paid to the attorney. *See Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003); *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003); *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959); *see also Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2003) (following *Cotnam* on *stare decisis* grounds, albeit reluctantly[2]); *Davis v. Commissioner*, 210 F.3d 1346 (11th Cir.

[2] After undertaking a lengthy analysis of the potential applicability of the assignment-of-income doctrine, the Fifth Circuit in *Srivastava* remarked that "were we to decide this case as an original matter, we

(Continued on following page)

2000) (following *Cotnam* as binding precedent from the former Fifth Circuit).

At the heart of the circuit split is the characterization of the contingency fee agreement. The majority of circuits view the contract as a mere promise on the part of the plaintiff to pay a portion of the recovery to the attorney if and when the recovery is obtained. On the other hand, the circuits in the minority treat the execution of the contract as a present transfer to the attorney of a portion of the underlying cause of action.[3] These latter courts conclude that the contingent fee paid to the attorney represents a liquidation of the attorney's portion of the claim. Consequently, under this view, the contingent fee does not "flow through" the plaintiff and, as a result, the plaintiff's gross income is limited to the portion of the total recovery that remains after the contingent fee is paid.

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might apply the anticipatory assignment doctrine to hold that contingent fees are gross income to the client." *Srivastava v. Commissioner*, 220 F.3d 353, 363 (5th Cir. 2003).

[3] Some courts in the minority base this characterization on the specifics of the applicable attorney's lien statute. *See, e.g., Banaitis v. Commissioner*, 340 F.3d 1074, 1083 (9th Cir. 2003) (relying on "the unique features of Oregon law" governing attorney liens); *Cotnam v. Commissioner*, 263 F.2d 119, 125 (5th Cir. 1959) (basing holding on Alabama attorney lien statute). However, other courts–including the Ninth Circuit itself–have determined that the nuances of state attorney lien law are not important in resolving the question of whether a present transfer occurs. *See, e.g., Banks v. Commissioner*, 345 F.3d 373, 385 (6th Cir. 2003) (quoting *Srivastava v. Commissioner*, 220 F.3d 353, 364 (5th Cir. 2000) for the proposition that its holding does not depend upon "the intricacies of an attorney's bundle of rights"); *Sinyard v. Commissioner*, 268 F.3d 756, 760 (9th Cir. 2001) (stating that "we do not see how the existence of a lien in favor of the taxpayer's creditor makes the satisfaction of the debt any less income to the taxpayer whose obligation is satisfied").

The purpose of this brief is to illustrate that regardless of the characterization accorded the contingency fee arrangement, the tax results are the same. That is, once a recovery is secured, the plaintiff must include the entire recovery in gross income–including the portion paid to the attorney. The plaintiff is left with a deduction for the amount of the attorney's fee. Accordingly, the debate undertaken by the lower courts concerning whether the plaintiff has assigned to her attorney future income from the claim or a portion of the underlying claim itself ultimately proves to be a wasted exercise.

I. CONTINGENCY FEE AGREEMENT AS A MERE PROMISE TO PAY

One view of the contingency fee arrangement is that the fee agreement constitutes an executory contract under which the plaintiff promises to pay the attorney a percentage of any amounts recovered on the claim in exchange for the attorney's agreement to provide services in connection with the prosecution of the claim. If and when the claim is reduced to a recovery, state law generally provides the attorney with an equitable lien on the recovered amounts to secure the plaintiff's payment obligation. However, under this view of the contingency fee arrangement, the attorney's potential future security interest in the recovered fund does not alter the characterization of what occurs upon the execution of the fee agreement. Rather, the fee agreement remains nothing more than the plaintiff's promise to pay a contingent amount of money in the future.

The income tax treatment of the contingency fee arrangement under this characterization is relatively

straightforward. As the fee agreement evidences only the plaintiff's promise to pay money to the attorney in the future, the execution of the fee agreement carries no immediate tax consequences. Rather, the tax consequences of the arrangement are deferred until the cause of action is prosecuted to a recovery. At that point, barring the application of an exclusion under § 104(a), the plaintiff includes the entire recovery in gross income. The portion of the recovery that the plaintiff pays to the attorney gives rise to a deduction. *See* IRC §§ 162(a), 212(1).[4]

The analysis described above does not change if the parties arrange for the defendant to pay the contingent fee directly to the attorney. Under the venerable case of *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929), the defendant's satisfaction of the plaintiff's obligation to pay the attorney is equivalent to the defendant's payment of the contingent fee directly to the plaintiff.[5] In other words,

[4] If the expense relates to the taxpayer's trade or business, including a trade or business of providing services as an employee, the deduction is governed by § 162(a). *See McKay v. Commissioner*, 102 T.C. 465, 488-89 (1994) (holding that costs of suing former employer for wrongful discharge were deductible under § 162), *vacated and remanded on another issue*, 84 F.3d 433 (5th Cir. 1996). If the expense does not relate to the taxpayer's trade or business, the deduction is governed by § 212(1).

[5] The Fifth Circuit in *Cotnam* concluded that the holding from *Old Colony Trust* was inapplicable in the context of a contingency fee arrangement. Specifically, the court reasoned that the taxpayer had previously discharged her obligation to her attorneys by assigning to them a portion of her claim by executing the fee agreement. *See Cotnam v. Commissioner*, 263 F.2d 119, 126 (5th Cir. 1959). Thus, the only way to avoid the application of *Old Colony Trust* is to view the execution of the contingency fee agreement as effecting a present transfer of a portion of the underlying cause of action. The tax consequences of this characterization of the contingency fee arrangement are addressed in section II below.

the plaintiff cannot escape taxation by procuring a direct payment of a portion of a taxable recovery to her creditor. *See Helvering v. Horst*, 311 U.S. 112, 116 (1940). Thus, as one would expect, the tax consequences of the transaction do not turn on something as trivial as the number of checks written by the defendant.

II. CONTINGENCY FEE AGREEMENT AS MORE THAN A MERE PROMISE TO PAY

Under an alternate view of the contingency fee agreement, the fee agreement represents more than the plaintiff's mere promise to pay the attorney a contingent amount of money. Instead, the plaintiff is considered to have presently transferred "something" to the attorney upon execution of the fee agreement. On one hand, the thing presently transferred could be described as a right to a percentage of the future proceeds of the claim. However, most courts adopting the present-transfer characterization of the contingency fee arrangement attempt to avoid application of the assignment-of-income doctrine by describing plaintiff as presently transferring to the attorney a portion of the underlying cause of action. Under this latter characterization, the plaintiff and the attorney emerge from the execution of the fee agreement as co-owners of the claim, with the relative ownership of the claim determined by the percentage contingency fee charged by the attorney. *See Estate of Clarks v. Commissioner*, 202 F.3d 854, 858 (6th Cir. 2000) (concluding that the contingency fee arrangement is "no different from the transfer of a one-third interest in real estate that is thereafter leased to a tenant"). Yet if the plaintiff indeed is properly viewed as making a present transfer to the attorney upon execution of the contingency fee agreement, whether the object of the

transfer is described as a portion of the future proceeds of the claim or a portion of the claim itself ultimately proves irrelevant. In either case, the tax consequences of the transaction would be governed by § 83.

A. Applicability of Section 83

Section 83 applies in any case where property is transferred in connection with the performance of services. In this regard, the concept of "property" for purposes of § 83 is rather broad. As provided in § 1.83-3(e) of the Treasury Regulations, the term includes all "real and personal property other than either money or an unfunded and unsecured promise to pay money or property in the future." Courts interpreting the scope of property under § 83 have affirmed the broad definition afforded by the regulation. *See, e.g., Theopolis v. Commissioner*, 85 F.3d 440, 445 (9th Cir. 1996) (contract to purchase stock is property under § 83); *Campbell v. Commissioner*, 943 F.2d 815 (8th Cir. 1991) (profits interest in a partnership is property under § 83); *Montelepre Systemed, Inc. v. Commissioner*, 61 T.C.M. (CCH) 1782, 1786, *aff'd*, 956 F.2d 496 (5th Cir. 1992) (right of first refusal is property under § 83). Accordingly, if the contingency fee agreement constitutes not merely the plaintiff's promise to pay money in the future but rather a present transfer of something from the plaintiff to the attorney, the fee agreement implicates § 83.[6]

[6] For a rebuttal of the possible taxpayer argument that the portion of the claim purportedly transferred to the attorney by way of the contingency fee agreement is not "property" for purposes of § 83, see Gregg D. Polsky, *A Correct Analysis of the Tax Treatment of Contingent*

(Continued on following page)

The general rule under § 83(a) provides that the excess of the fair market value of the transferred property over the amount paid for the property constitutes gross income to the service provider. However, if the transferred property is subject to a "substantial risk of forfeiture," the tax consequences of the transaction are held in abeyance until the risk of forfeiture lapses. Specifically, the service provider does not recognize gross income until the first time the service provider's rights in the property are not subject to a substantial risk of forfeiture. IRC § 83(a). For purposes of measuring the service provider's gross income, the value of the transferred property is its fair market value when the risk of forfeiture lapses. *Id.* On the other side of the transaction, the transferor realizes a gain on the transfer to the extent the fair market value of the property–determined when the risk of forfeiture lapses–exceeds the transferor's basis. Treas. Reg. § 1.83-6(b).[7] Finally, the transferor is entitled to deduct the amount included in the service provider's gross income when the transferred property is no longer subject to a substantial risk of forfeiture. IRC § 83(h). In short, the specific tax consequences of a transfer of property to which § 83 relates cannot be determined until the substantial risk of forfeiture, if any, lapses. At that point, the transfer is given full tax effect.

Attorney's Fee Arrangements: Enough with the Fruits and the Trees, 37 Ga. L. Rev. 57, 96-101 (2002).

[7] This regulation simply restates the well-established tax rule that when property is transferred in exchange for services, the transferor realizes gain or loss as if the property were sold for fair market value. *See International Freighting Corp. v. Commissioner*, 135 F.2d 310, 313 (2d Cir. 1943); *United States v. General Shoe Corp.*, 282 F.2d 9 (6th Cir. 1960), *cert. denied*, 365 U.S. 843 (1961); *Riley v. Commissioner*, 328 F.2d 428 (5th Cir. 1964).

B. Substantial Risk of Forfeiture

As evident from the framework described above, the concept of a "substantial risk of forfeiture" occupies a central role in the § 83 analysis. The statute provides that the service provider's rights in property are subject to a substantial risk of forfeiture "if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual." IRC § 83(c). The Treasury Regulations elaborate on the statutory definition by providing that a substantial risk of forfeiture exists:

> where rights in property that are transferred are conditioned, directly or indirectly, upon the future performance . . . of substantial services by any person, or the occurrence of a condition related to a purpose of the transfer, and the possibility of forfeiture is substantial if such condition is not satisfied.

Treas. Reg. § 1.83-3(c)(1). Considering this definition in the context of a typical contingency fee arrangement, it is clear that the attorney's interest in the portion of the claim that would be assigned to her by operation of the fee agreement (under the present-transfer characterization) is subject to a substantial risk of forfeiture. It goes without saying that an attorney's work is not completed once the contingency fee agreement is executed. Quite to the contrary, the attorney's work has just begun. In order for the attorney to realize full enjoyment of her portion of the claim–by obtaining her full contingent fee–the attorney must provide considerable future services on behalf of her client.

While the exact moment at which the attorney's right to payment of the contingent fee under the contract vests

depends on state law, the prevailing view among the jurisdictions to address the issue is that the attorney must prosecute the claim to the point of the occurrence of the contingency specified in the contract. *See, e.g., Potts v. Mitchell*, 410 F. Supp. 1278, 1282 (W.D.N.C. 1976) (holding that an attorney's equitable interest "could not become 'vested' in a contingent fee situation until the case was prosecuted to a favorable judgment or settled by the contracting attorney"). Short of that, the attorney generally is entitled only to the reasonable value of her services rendered on a *quantum meruit* basis.[8] *See, e.g., Ellerin & Assoc. v. Brawley*, 589 S.E.2d 626 (Ga. App. 2003); *Fracasse v. Brent*, 494 P.2d 9 (Cal. 1972); *Ambrose v. Detroit Edison Co.*, 237 N.W.2d 520 (Mich. Ct. App. 1975).[9] Thus, an attorney cannot execute a contingency fee agreement and then simply walk away with the right to a specified percentage of any eventual recovery. Rather, in order for the attorney to receive full enjoyment of the transferred portion of the claim, she generally must provide legal services until the claim is resolved.[10] At that point, the

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[8] Furthermore, if the attorney quits the case or is discharged for cause (*e.g.*, for failure to provide adequate representation) prior to final resolution of the claim, the attorney generally is entitled to no fee whatsoever. *See, e.g., Hardison v. Weinshel*, 450 F. Supp. 721, 723 (E.D. Wis. 1978); *Gary v. Cohen*, 231 N.Y.S.2d 394, 398 (N.Y. Sup. Ct. 1962); *Royden v. Ardoin*, 331 S.W.2d 206, 209 (Tex. 1960).

[9] For a survey of cases addressing this issue, see George L. Blum, Annotation, *Limitation to Quantum Meruit Recovery, Where Attorney Employed Under Contingent-Fee Contract is Discharged Without Cause*, 56 ALR 5th 1 (1998).

[10] In a minority of jurisdictions, an attorney terminated without cause is entitled to the contract fee. *See, e.g., Mandell & Wright v. Thomas*, 441 S.W.2d 841 (Tex. 1969) (holding that law firm discharged without cause entitled to contractual contingency fee when settlement was later obtained); *Jones v. Kubalek*, 334 P.2d 490 (Or. 1959) (holding

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substantial risk of forfeiture lapses and the attorney's rights in the portion of the claim transferred by way of the fee agreement become vested.

C. Tax Consequences Under Section 83

When the cause of action is prosecuted to a resolution and the attorney's substantial risk of forfeiture lapses, the tax consequences of the transaction finally take hold. Only at that point is the property transfer that occurred upon execution of the fee agreement taken into account for tax purposes.

Upon this lapse of the risk of forfeiture, the attorney has gross income for services rendered equal to the then fair market value of the portion of the claim previously transferred to the attorney. IRC § 83(a). Because the settlement of the claim liquidates the entire claim, the fair market value of the portion of the claim previously transferred from the plaintiff to the attorney will exactly equal

that attorney discharged without cause after filing complaint on behalf of client entitled to full contingency fee). Yet even in these jurisdictions, the plaintiff's entitlement to the contingent fee is subject to a substantial risk of forfeiture following the execution of the fee agreement. The attorney must continue to provide adequate services in connection with the plaintiff's claim to avoid being terminated for cause. In fact, the only instance in which an attorney's interest in the cause of action would vest sooner in these jurisdictions than in the majority of jurisdictions is if the attorney were in fact terminated without cause. In that event, an argument could be made that the difficulties inherent in valuing the portion of the claim transferred to the attorney should be deferred until the claim is later resolved pursuant to the open-transaction doctrine articulated in *Burnet v. Logan*, 283 U.S. 404 (1931).

the amount of the attorney's contingent fee.[11] At that point the plaintiff, who has transferred appreciated property with a zero basis to the attorney, recognizes a gain in the same amount.[12] Treas. Reg. § 1.83-6(b). This amount, when combined with the recovery on the portion of the claim retained by the plaintiff, leaves the plaintiff with gross income equal to the entire recovery. Finally, the plaintiff is entitled to a deduction for the amount of the contingent fee in the year such fee is included in the attorney's gross income. IRC § 83(h).[13] In this manner, the final tax consequences determined under § 83 where the plaintiff is viewed as making a present transfer to the attorney upon execution of the contingency fee agreement are the same as those under general tax principles where the contingency fee agreement is viewed as evidencing nothing more than the plaintiff's mere promise to pay money in the future. Under each scenario, the entire amount of the recovery constitutes gross income to the plaintiff, and the plaintiff is left with a deduction for the contingent fee paid to the attorney.

[11] As a technical matter, under the present-transfer characterization, the attorney gets paid cash in respect of his ownership interest in a portion of the claim. Therefore, when the attorney is paid, she is treated as receiving the payment in satisfaction of the attorney fee portion of the claim. However, because the attorney will take a fair market value basis in that portion of the claim, *see* Treas. Reg. § 1.61-2(d)(2)(i), she will have no further gain realization.

[12] This gain will be taxed as ordinary income under the substitution of ordinary income doctrine articulated in *Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 264-65 (1958).

[13] For an example demonstrating how § 83 applies under the present-transfer characterization, see Polsky, *supra* note 6, at 108-11.

III. FLAW IN ANALYSIS SUPPORTING EXCLUSION OF ATTORNEY'S FEE FROM GROSS INCOME

Those circuits that have determined that the plaintiff's gross income does not include the portion of the recovery paid to the attorney have grounded their analysis in the determination that the plaintiff transferred a portion of the underlying cause of action to the attorney upon executing the contingency fee agreement. Beyond failing to recognize the applicability of § 83 to the purported transfer of the claim, the ultimate flaw in the analysis employed by these courts is the failure to treat the transfer of the claim as a taxable transaction–ever. To the extent these courts address the tax ramifications of the transfer of the portion of the claim deemed to occur upon the execution of the contingency fee agreement, they do not treat the transfer as presently taxable. Rather, these courts cite the speculative or even worthless value of the claim as justification for deferring the tax consequences of the transaction. *See Estate of Clarks v. Commissioner*, 202 F.3d at 857 (describing the value of the taxpayer's lawsuit as "entirely speculative and dependent upon the services of counsel"); *Cotnam v. Commissioner*, 263 F.2d at 125 (stating that the taxpayer's claim was "worthless without the aid of skilled attorneys").[14] Yet once the claim is liquidated, the tax consequences resulting from the transfer of the portion of the claim from the plaintiff to the attorney continue to be ignored. At this point, the courts simply

[14] It is doubtful that the cause of action in the plaintiff's hands prior to the plaintiff retaining an attorney can properly be described as devoid of value. In any event, it is worth noting that § 83 applies to transfers of property made in connection with the performance of services even if the transfer lacks a compensatory element. *See Alves v. Commissioner*, 734 F.2d 478 (9th Cir. 1984).

conclude that the plaintiff and the attorney each have gross income to the extent of their proportional interest in the recovery. *See Cotnam v. Commissioner*, 263 F.2d at 125 (concluding that the contingent fee "was income to the attorneys but not [the taxpayer]"). Under the proper application of § 83 to this transaction, the transfer of the portion of the claim from the plaintiff to the attorney is not forever ignored from a tax perspective. Rather, the transfer is fully taxable to both parties at the time a recovery is obtained, which also happens to be the point at which the value of the transferred portion of the claim can be determined with certainty.

IV. THE RESULTING INEQUITY AND THE APPROPRIATE RESPONSE

Nothing concerning the conclusion that a plaintiff must include the entire recovery in gross income while taking a deduction for the contingent attorney's fee is particularly remarkable. Rather, the scenario fits squarely within the long-standing framework of the Internal Revenue Code under which expenses incurred by a taxpayer in generating gross income are recovered by way of a deduction.[15] If plaintiffs were entitled to the full benefit of the

[15] Some fellow academics recently have argued that the payment to the attorney should not be treated as a deduction; rather, the attorney's fee should be treated as a cost that is capitalized into the basis of the cause of action. When the cause of action is liquidated, they argue that the recovery is offset by such basis in determining the plaintiff's gross income. *See* Charles Davenport, *Why Legal Fees Are Not Deductible*, 97 Tax Notes 703 (Nov. 4, 2002); Charles Davenport, *Capitalization of Legal Fees: Professor Davenport Responds*, 97 Tax Notes 1237 (Dec. 2, 2002); *see also* Deborah A. Geier, *Davenport Has the Right Idea*, 97 Tax Notes 1627 (Dec. 23, 2002). This argument (the "capitalization argument") is inconsistent with the origin-of-the-claim

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deduction for their attorney's fees in computing their tax liability, it is doubtful that the inclusion-deduction treatment of the transaction would raise any eyebrows.

Of course, taxpayers in many cases do not enjoy the full benefit of their deductions for attorneys' fees. Rather, in those situations where the deduction is relegated to the status of a miscellaneous itemized deduction,[16] the deduction is subject to a number of limitations. *See* IRC §§ 56(b)(1)(A), 67(a), 68(a). Generally, the most significant of these limitations is the complete disallowance of the deduction in determining the taxpayer's liability under the

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doctrine, which provides that costs of litigating entitlement to a payment of income are deductible whereas legal costs relating to the acquisition of property must be capitalized. *See, e.g., Woodward v. Commissioner*, 397 U.S. 572 (1970); *United States v. Hilton Hotels Corp.*, 397 U.S. 580 (1970); *Southland Royalty Co. v. United States*, 582 F.2d 604 (Ct. Cl. 1978); *see also* Treas. Reg. § 1.212-1(k). Thus, under the origin-of-the claim doctrine, the cause of action itself is disregarded as a separate asset and the tax treatment (*i.e.*, deduct immediately or capitalize) of the legal costs incurred in prosecuting the cause of action are determined by the nature of the underlying claim. If the case were otherwise–that is, if the legal right to a payment of income were treated as a separate item of property for tax purposes–then the established distinction between income and property under the Internal Revenue Code, the Treasury Regulations, and caselaw would be effectively eliminated. *See* Brant J. Hellwig, *Davenport's Capitalization Argument Fails to Convince*, 98 Tax Notes 433 (Jan. 20, 2003). The only court to consider an argument similar if not identical to the capitalization argument rejected it. *See Alexander v. I.R.S.*, 72 F.3d 938, 941-44 (1st Cir. 1995).

[16] If the underlying cause of action does not relate to the taxpayer's trade or business, the deduction afforded under § 212(1) is treated as a miscellaneous itemized deduction. *See* IRC §§ 62(a), 63(d), 67(b). Even if the cause of action relates to the taxpayer's trade or business, the deduction under § 162(a) is a miscellaneous itemized deduction if the taxpayer's trade or business consists of the performance of services as an employee. *See* IRC § 62(a)(1), (a)(2)(A); *see also Biehl v. Commissioner*, 351 F.3d 982 (9th Cir. 2003).

alternative minimum tax (AMT). *See Alexander v. I.R.S.*, 72 F.3d 938, 946 (1st Cir. 1995) (noting that the disallowance of the deduction under the AMT "smacks of injustice"). Because these limitations on miscellaneous itemized deductions tend to produce unfair or even draconian results in certain contexts, it is understandable that taxpayers would attempt to circumvent these limitations by arguing that the attorney's fee should be regarded as an exclusion from gross income. For that matter, it is understandable that courts would be sympathetic to the plight of these taxpayers and, consequently, to their argument. Indeed, with regard to the cases presently before the Court, no justifiable reason exists why Mr. Banks or Mr. Banaitis should be taxed on anything more than the amount of the recovery they retained after making payment to their attorneys.[17]

Nonetheless, fundamental principles of taxation should not be ignored in order to reach the equitable result in these and similar cases. As this Court has noted:

> It is not enough merely that hard and objectionable or absurd consequences, which probably were not within the contemplation of the framers, are produced by an act of legislation. Laws enacted with good intention, when put to the test, frequently, and to the surprise of the law maker himself, turn out to be mischievous, absurd, or otherwise objectionable. But in such case

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[17] *See* Polsky, *supra* note 6, at 73; Robert J. Peroni, *Reform in the Use of Phaseouts and Floors in the Individual Income Tax System*, 91 Tax Notes 1415, 1425 (2001) (each concluding that the deduction limitations should not, as a policy matter, apply to these sorts of payments).

> the remedy lies with the law making authority, and not with the courts.

Crooks v. Harrelson, 282 U.S. 55, 60 (1930) (citations omitted). Equity in taxation is a political concept, one that should and must be resolved by the legislative body. *See Kenseth v. Commissioner*, 259 F.3d 881, 885 (7th Cir. 2001). Congress created the legislative defect that results in the unfortunate and unjustified overtaxation of certain plaintiffs. One would hope that Congress eventually will heed the repeated calls to correct it.[18]

CONCLUSION

In a broad sense, the effect of the execution of a contingency fee agreement is susceptible to two interpretations. The fee agreement constitutes the plaintiff's executory promise to pay a portion of the claim proceeds to the attorney in the future, or, alternatively, the execution of the fee agreement transfers a portion of the underlying cause of action from the plaintiff to her attorney. While the latter interpretation appears to be driven by a desire to achieve a more favorable and equitable tax result for the plaintiff, it ultimately fails to achieve this goal. The proper

[18] In that regard, we offer a simple legislative solution. Section 62(a) should be amended to include among those deductions allowed in computing adjusted gross income "deductions allowed under sections 162 or 212 which consist of expenses paid or incurred in connection with the prosecution of a cause of action." As of the filing of this brief, Congress is considering a more complicated and under-inclusive legislative solution than the one proposed above. *See* Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. § 643(a) (2004) (proposing a new § 62(a)(19) to afford above-the-line status to deductions for legal fees and court costs in certain discrimination cases).

application of § 83 to the transferred portion of the claim leads to the same result achieved under general tax principles if the contingent fee contract is viewed as the plaintiff's mere promise to pay money in the future–the plaintiff must include the entire recovery in gross income. For this reason, the judgments of the United States Courts of Appeals for the Sixth Circuit and the Ninth Circuit should be reversed.

Respectfully submitted,

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In The
Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

JOHN W. BANKS, II,

Respondent.

COMMISSIONER OF INTERNAL REVENUE,

Petitioner,

v.

SIGITAS J. BANAITIS,

Respondent.

On Writs Of Certiorari To The United States Courts Of Appeals For The Sixth And Ninth Circuits

BRIEF FOR *AMICUS CURIAE* TAXPAYERS AGAINST FRAUD EDUCATION FUND IN SUPPORT OF RESPONDENTS

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INTEREST OF *AMICUS CURIAE*

Amicus curiae Taxpayers Against Fraud Education Fund ("TAF"), is a nonprofit public interest organization dedicated to combating fraud against the federal government through the promotion of the *qui tam* provisions of the False Claims Act, 31 U.S.C. § 3729 *et seq.* (2004) ("FCA") and the support of whistleblowers who use the Act.[1] The *qui tam* provisions of the FCA permit a private relator to file suit on behalf of the United States alleging violations of the FCA. In addition, the FCA provides for a portion of any recovery generated by such a suit to be paid to the *qui tam* relator who brought the case. Typically, FCA relators will hire attorneys on a contingency fee basis (indeed, two circuits have held that FCA relators are prohibited from bringing their actions *pro se*).[2] TAF therefore has a strong interest in ensuring that contingency fee payments paid to lawyers representing *qui tam* relators are not includible in the taxable income of those *qui tam* relators.

SUMMARY OF ARGUMENT

1. The "assignment of income" doctrine operates as a judicial gloss on the interpretation of the federal tax code: where a taxpayer assigns to another party an item of revenue that he has "earned" (or "is otherwise the source

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[1] Pursuant to Supreme Court Rule 37.6, counsel for *amicus* represents that it authored this brief and that no person other than counsel or *amicus* made a monetary contribution to its preparation or submission. All parties have consented to the filing of this brief.

[2] *See United States ex rel. Lu v. Ou*, 368 F.3d 773 (7th Cir. 2004); *United States v. Onan*, 190 F.2d 1 (8th Cir. 1951).

of the right to receive and enjoy"), the assignor taxpayer will be required to include that revenue in his taxable income. This doctrine typically does not apply, however, where the assignor taxpayer has "gone into business with" the assignee, such as where the taxpayer assigns his income to a partnership, to a corporation, or to a principal of which he is the agent.

When a plaintiff hires a lawyer on a contingency fee basis, he and the lawyer have in a very real sense joined together in an enterprise – the enterprise of converting the plaintiff's cause of action into money damages. It is well established that where two taxpayers undertake a joint venture, they may be treated as a partnership for tax purposes, even if they have not formally established a partnership under state law. Thus, since the assignment of income doctrine is not invoked to override the assignments of income agreed upon between bona fide partners, it ought not apply in the contingency fee context. Both the plaintiff and his lawyer are individually taxable on their respective shares of any final damage award or settlement, according to their agreed upon shares. There is no basis for requiring both the plaintiff and the lawyer to pay tax on the amount paid to the lawyer.

2. Even if the Court concludes that respondents in the instant cases must include in their taxable incomes amounts paid to their attorneys as contingency fees, it should recognize that a very different case is presented by a *qui tam* relator under the FCA. Because the FCA relator is not advancing his own cause of action, but is instead advancing a claim belonging solely to the Government, he cannot properly be described as the one who "earns" or "is otherwise the source of the right to receive and enjoy" the income. Rather, he is merely an assignee himself, both of

the Government's cause of action and of a certain portion – from 15 to 30 percent – of any recovery received from that cause of action. In sub-assigning a portion of his own assigned share to a lawyer under a contingency fee agreement, the FCA relator has not assigned his own income, but has instead sub-assigned a portion of the Government's income. Therefore, the logical predicate for applying the assignment of income doctrine does not exist in the FCA context.

Indeed, it is commonplace for multiple FCA relators to combine their knowledge of a defendant's wrongdoing, and to bring a *qui tam* action together, or to merge their efforts after filing separate *qui tam* cases. In this context, it is unthinkable that the IRS would seek to tax any one of the co-relators on the full amount of the FCA bounty that is paid out to all of them. Rather, it is common practice for each relator to include in his taxable income only that portion of the FCA reward that he or she actually receives. Just so, where a lawyer, like an additional relator, is paid a separate share of the FCA reward, that portion should be taxable only to the lawyer.

Any other result would contradict the policy Congress sought to advance in enacting and amending the FCA. That policy is clear: to provide a financial incentive sufficient to encourage *qui tam* relators to root out and expose fraud against the Government, and to discourage Government contractors from engaging in such fraud in the first place. Forcing *qui tam* relators to pay tax on the contingency fee amounts paid to their lawyers will reduce the total incentive to the relator by close to 50 percent. Since there is certainly no evidence that Congress understood that relators would be subject to the "assignment of income" doctrine when it amended the FCA in 1986,

applying any such result to the FCA context would be in conflict with Congressional intent.

ARGUMENT

I. The "Assignment Of Income" Doctrine Does Not Require A Plaintiff To Include The Contingency Fee Portion Of An Award In His Taxable Income

The Government asserts that this case can be resolved solely by reference to the federal law proposition "that income is to be taxed to the person who earns it, even when it is paid at that person's direction to someone else." Pet. Br. at 11 (citing *Lucas v. Earl*, 281 U.S. 111, 114-15 (1930)). For that reason, the Government says that it is unnecessary to determine "the precise nature and scope of the right obtained by an attorney pursuant to a contingent fee agreement." Pet. Br. at 12. All that is required is to determine the identity of the plaintiff, and to tax him or her on the full amount of any judgment or settlement procured in the litigation, disregarding any contract, assignment, or other arrangement entered into by that plaintiff. In addition, of course, the Government will tax the lawyer on the amounts he receives from the plaintiff. Thus, applying the assignment of income doctrine in this context results in two taxpayers paying tax on the same revenue: according to the Government, both the plaintiff and the lawyer must include the contingency fee in their taxable income.

To be sure, the Government concedes that the Internal Revenue Code "'creates no property rights but merely attaches consequences, federally defined, to rights created under state law.'" Pet. Br. at 15 (quoting *United States v. National Bank of Commerce*, 472 U.S. 713, 722 (1985)). Nevertheless, the Government asserts that "under any view of state law" the respondents are taxable on the full amount of the settlement proceeds arising out of their lawsuits because federal tax law will simply disregard any attempted assignment of an interest in said settlements to their lawyers. In support of this assertion, the Government invokes the "assignment of income" doctrine, which holds "that a taxpayer cannot avoid the rule that income is taxed to the person who earns it by making an anticipatory assignment of income, even where the taxpayer assigns income that he has not yet earned the right to receive." Pet. Br. at 19.

The Government's use of this doctrine to require plaintiffs to pay income tax on the contingency fees earned by their lawyers has, unsurprisingly, led to a split in the circuits. The two seminal decisions by this Court establishing the assignment of income doctrine arose in very different contexts: in both cases, a taxpayer sought to assign a portion of his future income to a family member as a tax-free gift, thereby allowing the income to be enjoyed free of any income tax. *See Lucas v. Earl*, 281 U.S. 111, 113-14 (1930) (husband sought to assign future salary to wife); *Helvering v. Horst*, 311 U.S 112, 114 (1940) (father sought to assign bond coupons to son). In that context, where the income interest is being assigned *from* "the person who earns it," and where the assignee of the income interest has done nothing in exchange for the gift and will pay no tax on that gift, it is not difficult to see why this Court would apply a judicial doctrine designed to ensure that the Tax Code would "tax salaries to those *who earned them* and provide that the tax could not be escaped by anticipatory arrangements and contracts however

skillfully devised to prevent the salary when paid from vesting even for a second in the man who earned it." *Earl*, 281 U.S. at 114-15 (emphasis added).

It is difficult, however, to understand why this assignment of income doctrine should apply where the income interest is being transferred *to* the person who "earns it," and who will also pay tax on it. Indeed, in a variety of ordinary commercial contexts, the assignment of income doctrine clearly is not applied, and valid assignments are made and respected by the Tax Code. For example, it is obviously permissible for a taxpayer to enter into a partnership with another taxpayer, and to agree that any income he earns on certain kinds of projects will be assigned to the partnership, to be distributed according to the allocation of partnership shares. *See generally* 26 U.S.C. §§ 701-704 (2004); *Schneer v. Commissioner*, 97 T.C. 643 (1991) (portion of lawyer's fees generated from work performed for one client were properly assigned to firm subsequently joined by the lawyer). Likewise, the tax law will normally respect as valid an individual's assignment to a corporation of a portion of the income to be earned by the taxpayer's services or from his property. *See generally Investment Research Assoc. v. Commissioner*, 78 T.C.M. (CCH) 951, 1071 (1999) (summarizing circumstances in which taxpayers may assign personal service income to a personal service corporation). It is also well-established that where an agent earns money that it is obligated to pay over to its principal, that money is excluded from the gross income of the agent, and is included only in the gross income of the principal. *See generally* 1965-2 C.B. 21 (Rev. Rul. 65-282) (where lawyer represents indigent client and is awarded attorneys fees that he is obligated to pay over

to legal aid society, the awarded fees are included in the gross income only of the legal aid society).[3]

Thus, the resolution of the issue presented in this case depends upon whether a plaintiff's assignment to his lawyer of a portion of the proceeds from a lawsuit, in exchange for legal services, is more akin to (a) a gift of income to one who has not provided anything in return, or (b) a commercial arrangement in which the lawyer essentially becomes a risk-sharing partner with the plaintiff in their joint venture to successfully prosecute a legal claim. Four circuits have concluded that, at least under certain state laws, a plaintiff's contingency fee arrangement with his lawyer is more akin to a joint venture, and that therefore the plaintiff is not taxable on that portion of a judgment or settlement which he must pay to his lawyers in accordance with their prior agreement.[4]

These cases generally recognize that a plaintiff's cause of action typically will have significant value only if advanced by a competent lawyer. Since both the plaintiff who has the cause of action and the lawyer who enables him to advance the claim assume the risk that the claim

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[3] Indeed, in a context that seems indistinguishable from the instant cases, the IRS has recognized that the portion of a settlement used to cover attorney fees should not be included in the gross income of the plaintiffs. *See* 1980-2 C.B. 294 (Rev. Rul. 80-364) (where union sues employer on behalf of members and receives settlement payment, members do not have to include in their gross income the amount of the settlement that is kept by the union to cover its attorney fees).

[4] In addition to the decisions below of the Sixth and Ninth Circuits, the following cases were likewise decided in favor of the taxpayer on this issue: *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000); *Estate of Clarks v. United States*, 202 F.3d 854 (6th Cir. 2000); *Foster v. United States*, 249 F.3d 1275 (11th Cir. 2001).

will fail, they both "earn" the income ultimately yielded by the litigation of that claim. Accordingly, both parties should be taxed on any income produced by the action in accordance with the ratios set forth in their prior agreement on how to divide the income between them.

Perhaps the best illustration of this analysis can be found in the first case to address the application of the assignment of income doctrine to the contingency fee context. In *Cotnam v. Commissioner*, 263 F.2d 119 (5th Cir. 1959), the taxpayer claimed an entitlement to a portion of the estate of a man she had served as a personal attendant during the last years of his life. When the Administrator of the decedent's estate refused to recognize Mrs. Cotnam's claim, "she was a long way from having the equivalent of cash," and therefore was also a long way from realizing any income for tax purposes. 263 F.2d at 125. Indeed, to convert her legal claim into any form of taxable income, Mrs. Cotnam was effectively required to hire an attorney:

> Her claim had no fair market value, and it was doubtful and uncertain as to whether it had any value. The only economic benefit she could then derive from her claim was to use a part of it in helping her to collect the remainder. Accordingly she, in effect, assigned to her attorneys forty per cent of the claim in order that she might collect the remaining sixty per cent. That was not the assignment of income of Mrs. Cotnam within the doctrine of *Lucas v. Earl*.

Id. (citation omitted).

In short, hiring a lawyer on contingency fee can be likened to a standard partnership or joint venture in which one party agrees to share the income from a certain asset if the other party agrees to perform services that are

thought to be critically important in generating income from that asset. In such a context, unlike the husband-to-wife assignment in *Earl*, it is simply not accurate to assert that the taxpayer is trying to attribute fruits "to a different tree from that on which they grew." *Earl*, 281 U.S. at 115. Rather, as the Fifth Circuit recognized in *Cotnam*, the plaintiff's tree "had borne no fruit and would have been barren if she had not transferred a part interest in that tree to her attorneys, who then rendered the services necessary to bring forth the fruit." 263 F.2d at 126.

To be sure, where the lawyer is paid on an hourly-fee basis, the plaintiff will have to pay tax on the full amount of any recovery, and can be said to have paid the lawyer on an "after-tax" basis. But that is also true of the farmer who chooses to pay a laborer to tend to his trees: the farmer will pay tax on the full amount of income earned from the fruit of his trees, and must pay for his labor on an "after-tax" basis. Where the farmer, however, chooses instead to form a partnership with his laborer, with both parties taking on the risks of the enterprise in exchange for a share of whatever the trees might produce, that joint venture will be taxed as a partnership – i.e., the farmer will include in his taxable income only the amount that he has not assigned away to his "partner," the laborer. *See, e.g., Baughn v. Commissioner*, 28 T.C.M. (CCH) 1447 (1969) (where substance of taxpayers' arrangement was a partnership, it will be taxed as a partnership even if taxpayers did not utilize the partnership form); *see also United States ex rel. Perler v. Papandon*, 331 F.3d 52, 55 (2d Cir. 2003) (citing *Baughn* for proposition that "[I]ndividuals may constitute a partnership for tax purposes even though they expressly disclaim any intention to enter into a partnership relation." 28 T.C.M. (CCH) at 1456.).

In sum, this Court should recognize the critical distinction between a partner who shares risk, and a service-provider who is paid irrespective of outcome. Even if the two are bound by professional ethics to provide identical services under either construct, as a matter of economic reality, there is a world of difference between the two. Ordinarily, the tax law recognizes this difference by taxing the "partner" differently from the service provider. The same result should obtain where the risk-taking partner is a lawyer working on a contingency fee basis.

II. Under No Circumstances Should The Contingency Fee Portion Of A *Qui Tam* Award Be Included In The Taxable Income Of A False Claims Act Relator

Even if the Court concludes that plaintiffs such as Banks and Banaitis must pay tax on contingency fee amounts paid to their lawyers, *amicus curiae* TAF respectfully submits that the Court should explicitly recognize that the taxation of contingency fee payments made to lawyers representing FCA relators presents an entirely distinct question, not presented in this appeal. Furthermore, as explained below, FCA relators should not be taxed on contingency fee payments.

A. An FCA Relator Does Not Advance His Own Cause Of Action, But Is Merely An Assignee Of The Government's FCA Claim

The Government's central argument in these cases proceeds from the following premise:

> There is no doubt that, under any view of state law, respondents were the sole plaintiffs in their causes of action and would have been required to include the entire taxable proceeds from those causes of action in their gross income if the proceeds had been paid directly to them. Indeed, by their nature, the basis of respondents' claims was the recovery of lost income.

Pet. Br. at 16. Given that respondents were the "sole plaintiffs" seeking "the recovery of lost income," – they are the ones, according to the Government, who "actually *earned* the income," and hence must "remain[] taxable" on that income even though it is paid to their lawyers. Pet. Br. at 16 (emphasis added) (quoting *Commissioner v. Sunnen*, 333 U.S. 591, 604 (1948)).

This premise is wholly inapposite to the *qui tam* context. An FCA relator is never "the sole plaintiff" and could never possibly be expected to include "the entire taxable proceeds" in his gross income. Unlike the typical plaintiff advancing his own cause of action, the *qui tam* plaintiff is advancing a cause of action *on behalf of* the United States Government. *See, e.g.*, 31 U.S.C. § 3730(b)(1) (2004) (authorizing *qui tam* action "in the name of the Government"). Indeed, in upholding the relator's Article III standing to bring a *qui tam* action, this Court relied specifically upon "the doctrine that the assignee of a claim has standing to assert the injury in fact suffered by the assignor." *Vermont Agency of Natural Res. v. United States*, 529 U.S. 765, 773 (2000). In so doing, the Court made clear that the *qui tam* relator is not advancing his own cause of action based upon his own injury, but is instead advancing the Government's cause of action based upon its injury. *See id.* at 774 (it is "the United States' injury in fact [that] suffices to confer standing on [the *qui tam* relator]").

A *qui tam* relator's sole interest in an FCA suit is the statutory bounty, which ranges from 15 to 25 percent of any damages recovery for cases in which the Government intervenes, and from 25 to 30 percent for cases in which the Government does not intervene. 31 U.S.C. § 3730(d) (2004). These amounts represent assignments of the *Government's* damages; the relator is merely an assignee of these amounts, and therefore does not "earn" them or claim entitlement to them in the same way that he could an award of his *own* damages. Even if the Government elects not to intervene, so that the relator and his lawyer do all of the work required to uncover the fraud and to successfully litigate the claim to judgment, the relator clearly could not be taxed on the entire amount of that judgment, since it belongs to, and will be paid over to, the Government. Indeed, requiring a *qui tam* relator to include in his taxable income the "entire proceeds" of an FCA recovery would nullify the financial incentives underlying the *qui tam* provisions, for the tax bill on the entire recovery would substantially exceed the bounty.

Moreover, Congress explicitly provided that the amount of the *qui tam* bounty should vary depending upon the relator's contribution to a successful outcome. 31 U.S.C. § 3730(d). Since the relator's contribution to the ultimate outcome will depend in large part on the work and skill of the relator's lawyer, in a very real sense the *qui tam* bounty is "earned" to that extent by the lawyer, and not by the relator. Indeed, by mandating a higher bounty in cases in which the Government declines to intervene, Congress recognized the added value in such cases of the skill and hard work of the relator's lawyer, who therefore can be understood to have *solely* "earned" that amount. In contrast to the typical case of a plaintiff

advancing his own cause of action, in the FCA context it is simply not possible to assert that the relator is the party who "earns" or "is the source of" the ultimate damage recovery.

In addition, unlike the typical plaintiff (and unlike respondents here), the *qui tam* relator is not seeking "the recovery of lost income." Pet. Br. at 16. A plaintiff suing for, say, breach of contract or employment discrimination seeks to recover amounts that should have been paid to that plaintiff, and that would have been taxable to that plaintiff had they been properly paid. This fact has been relied upon as supporting the conclusion that the plaintiff must be taxable on the full amount of any damage award, without reduction for contingency fee payments. *See, e.g.*, *Kenseth v. Commissioner*, 259 F.3d 881 (7th Cir. 2001) (settlement proceeds were "lost income" and hence taxable to the plaintiff). By contrast, the FCA relator seeks an award of damages to compensate for losses suffered solely by the Government, which is the "real party in interest." *See, e.g.*, *United States v. Health Possibilities*, 207 F.3d 335, 341 (6th Cir. 2000) ("Nor does the right to 'conduct' the action annul the government's status as the real-party-in-interest in *qui tam* litigation."). An award or settlement arising out of an FCA case represents the repayment of money that should have been paid solely to the Government, and that would therefore not have been taxable to any party had it been properly paid in the first place. Thus, the damages the FCA relator seeks to recover are not designed to compensate the relator for the loss of income which would have been taxable had it been rightfully paid. Accordingly, the Government's logical predicate for requiring plaintiffs to pay tax on the contingency fees paid to their lawyers is inapplicable in the FCA context.

B. Congress Has Explicitly Provided For The Assignment Of FCA Claims

In explaining the "assignment of income" doctrine, the Government sets forth the following distinction:

> Thus, where a taxpayer assigns income-producing property to another, thereby relinquishing all control over it, that taxpayer gives up the power to use that property in such a way as to realize a gain. But where a taxpayer retains control over an income-producing asset, that taxpayer has the power to gain through the satisfaction of assigning its income to whomever he pleases. Such a gain is gross income.

Pet. Br. at 22 (citing *Horst*, 311 U.S. at 117).

Applying this principle to the context of a plaintiff advancing his own cause of action, the Government argues that such a plaintiff ultimately retains "the sole power to assert and settle [his] cause[] of action." Pet. Br. at 25. In other words, the Government equates a plaintiff's control over his cause of action with "retain[ed] control over an income-producing asset," arguing that because a plaintiff's assignment of a portion of the income that might be generated from that controlled "asset" must be disregarded for tax purposes.[5] Because the Government takes this position irrespective of the rights that state law might

[5] The *Cotnam* court, however, explained why it is incorrect to hold that a plaintiff who exchanges a contingency fee promise for legal services has "fully enjoyed the benefit of his (her) economic gain represented by his (her) right to receive income." 263 F.2d at 126. "[W]here the only economic benefit to the taxpayer [from the assignment] was as an aid to the collection of a part of an otherwise worthless claim," the assignment of income doctrine "can have no just or realistic application." *Id.*

attribute to the lawyer who receives a contingency fee interest, it is implicitly asserting that a plaintiff *can never* assign a portion of his cause of action itself (i.e., his "income producing asset") to his attorneys. In other words, at least for federal tax purposes, the Government asserts that a plaintiff's cause of action is "nonassignable."

This argument cannot be applied to the FCA relator. A *qui tam* relator, in contrast to a plaintiff advancing his own cause of action, is litigating a claim that Congress has already decided to partition and assign. Since the entirety of any award or settlement recovered under the FCA is based solely upon the damages suffered by the Government, the bounty paid to the *qui tam* relator is, by definition, an assignment of the Government's FCA claim. Indeed, in upholding the Article III standing of private relators to bring FCA claims, this Court explicitly recognized that "[t]he FCA can reasonably be regarded as effecting a partial assignment of *the Government's damages claim*." *Vermont Agency of Natural Res.*, 529 U.S. at 773 (emphasis added).

Thus, even if this Court accepts the Government's assertion that, for federal tax purposes, a plaintiff's cause of action is "nonassignable," it must recognize that such an assertion simply cannot be made with respect to an FCA claim: since Congress has already assigned a portion of the FCA claim to qualifying relators, it necessarily follows that the FCA claim is "assignable."[6]

[6] Moreover, because the Government is the "real party in interest," an FCA relator does not have the "control" over an FCA case that a plaintiff has over his own cause of action. *See generally United States v. Health Possibilities*, 207 F.3d 335, 341 (6th Cir. 2000) (voluntary dismissal by *qui tam* plaintiff could not be approved without Attorney

(Continued on following page)

C. The Tax Law Should Not Distinguish Between FCA Assignments Made To Other Relators And Those Made To Lawyers

It is a common practice under the *qui tam* provisions of the FCA for multiple relators to file suit with respect to the same or similar wrongdoing. While there are first-to-file rules in the FCA that prohibit "tag along" cases, it is very often the case that two or more whistleblowers will combine their knowledge regarding the defendant's wrongdoing and join forces in challenging it. For example, in some circumstances, it may be that no one relator has sufficient knowledge to allege an FCA violation with the particularity required under FED. R. CIV. P. 9(b), and therefore two or more relators are necessary for a valid FCA complaint to be filed. In other instances, multiple different *qui tam* complaints may be filed, and the various relators will subsequently decide that it is in their mutual interest to combine forces, rather than to undertake costly litigation over whether the later-filed complaints should be viewed as separate cases or as prohibited "tag alongs."

In any event, it is commonplace, especially in large cases, that more than one relator will receive a portion of the FCA statutory bounty. Ordinarily, the relators will agree among themselves as to the respective shares of the overall bounty that each should receive. TAF is not aware of a single instance in which the IRS has asserted that one

General's consent); *see also United States ex rel. Milam v. University of Texas*, 961 F.2d 46, 50 (4th Cir. 1992) ("[T]he United States is the real party in interest in any False Claims Act suit, even where it permits a *qui tam* relator to pursue the action on its behalf."). For this reason, too, federal tax law should not disregard an FCA relator's assignment of an interest in the ultimate FCA award.

relator in a multiple-relator case must be required to include the entire amount of the statutory bounty in his or her taxable income. Nor can we imagine how such an assertion could ever be successfully advanced: First, where multiple relators have agreed to divide the statutory bounty among themselves, the IRS would have absolutely no basis for asserting that one of those relators should be deemed to have first received the entire amount. Second, requiring any single relator to include the entire amount of a divided bounty in his or her taxable income would massively reduce the incentive structure that Congress so carefully put into place in amending the FCA in 1986.

Thus, it appears established that the 15 to 25 percent bounty paid to qualifying *qui tam* relators (or 25 to 35 percent in nonintervened cases) may be divided and assigned among multiple relators without triggering the "assignment of income" doctrine. And if relators A and B may divide and assign the FCA's statutory bounty without exposing either one of them to federal tax liability on the full amount, then it follows that relator A may make the same kind of assignment to his lawyer. Stated differently, if the tax law's "assignment of income" doctrine does not disregard A's assignment of some portion of the *qui tam* bounty to relator B, then it also should not disregard A's assignment of that same interest to his lawyer.

Furthermore, at least two circuits have held that a relator is not legally permitted to bring an FCA case without a lawyer. *See United States ex rel. Lu v. Ou*, 368 F.3d 773, 775 (7th Cir. 2004) ("*pro se* relator cannot prosecute a *qui tam* action, because he is acting as an attorney for the government" (emphasis added)); *United States v. Onan*, 190 F.2d 1 (8th Cir. 1951) (same). And, as a practical matter, the lawyer rather than the relator often must

invest the greater resources into prosecuting an FCA case. Given these two realities, it would be manifestly unfair for the tax law to disregard a relator's assignment of an interest in the *qui tam* award to his lawyer, and to treat the relator as being "in sole control" of the entire case.

D. Public Policy Concerns Dictate That FCA Contingency Fees Should Not Be Taxed To FCA Relators

Finally, there are gravely important public policy concerns relating to the question of how to tax contingent legal fees in the FCA context that are not raised in the present case.[7] Congress has explicitly provided a financial incentive to encourage whistleblowers to step forward and to bring suit in order to vindicate the public interests protected by the statute. *See generally United States ex rel. Ramseyer v. Century Healthcare Corp.*, 90 F.3d 1514, 1520 (10th Cir. 1996) (1986 amendments' expansion of jurisdiction over *qui tam* actions reflects Congress' "concern that the government was not pursuing known instances of fraud.") (citation omitted); *United States ex rel. Fine v. Sandia Corp.*, 70 F.3d 568, 572 (10th Cir. 1995) ("Congress instituted the *qui tam* provisions of the FCA to encourage private citizens to expose fraud that the government itself cannot easily uncover."). *United States v. NEC Corp.*, 11 F.3d 136, 139 (11th Cir. 1993) ("The purpose of the *qui tam* provisions is to provide individuals with incentive to

[7] These concerns are similar to those raised by statutory causes of action with respect to which Congress has provided that the "prevailing party" may recover attorney fees and costs. *See Amici Curiae* Brief of Mountain States Legal Foundation, et al., Nos. 03-892 and 03-907 (U.S. filed Aug. 18, 2004).

inform the government of fraudulent activity and to compensate such relators for the time and expense of coming forward with such information.").[8]

Congress surely intended FCA relators to pay income tax on any amounts actually received under the FCA. But Congress likely did not intend to substantially drain the statutory bounty of its force as an incentive by requiring FCA relators to pay income tax on amounts that they do not actually receive.

For example, consider an FCA case in which the statutory award to the *qui tam* relator is $1 million. Under the Government's tax scheme, the relator's bounty would likely net out to approximately $250,000. The calculation is straightforward. The relator pays a $400,000 tax on the full $1 million (this assumes a 40% combined federal and state tax rate). He then pays an additional $350,000 (35%) to his lawyer, a fee which would not be unreasonable in light of the considerable investment and risk ordinarily associated with FCA cases.[9] If the $350,000 contingency fee paid to the lawyer is not taxable to the relator, his taxable income is $650,000 and his net bounty is thus approximately $390,000. Obviously, the effect of the tax regime advanced by the Government in this case would dramatically reduce the financial incentive offered to *qui tam* relators to come forward – often at great personal

[8] Indeed, the FCA itself provides that successful *qui tam* relators, in addition to being entitled to the statutory bounty, are also entitled to recover attorney fees and costs. 31 U.S.C. § 3730(d)(1) – (2) (2004).

[9] The lawyer then pays a $140,000 (40%) tax on his $350,000 portion of the award, leaving him with $210,000. Thus, the total net, after-tax return to the two individuals responsible for bringing the FCA action would be $460,000, less than half the $1 million bounty.

expense and professional risk – to blow the whistle on those who are defrauding the Government.

CONCLUSION

For the forgoing reasons, the Court should affirm the decisions below, or, at a minimum, reserve the question whether FCA relators must pay income tax on any portion of a statutory bounty paid to their lawyers under a contingency fee agreement.

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